

# The **GSE** REPORT™

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## ***Major Events***

### ***The Fannie Mae and Freddie Mac bailout:***

Congress passes the Housing and Recovery Act of 2008

Just how “temporary” will the federal government’s explicit guarantee of the GSEs be?

Congress gives Fannie and Freddie a “get out of jail free” card

What should be done with Fannie and Freddie?

Do we need Fannie and Freddie at all?

Unintended consequences?

How did we get in this mess?

*Who* are we bailing out?

Time to pull the plug on the Fannie Mae and Freddie Mac charade

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Mr. and Mrs. Taxpayer—Meet Fannie and Freddie...

Take taxpayers off hook for rot at Fannie, Freddie

### Congress passes the Housing and Recovery Act of 2008

- Congress approved the Housing and Economic Recovery Act of 2008 (H.R. 3221) by votes of 272-152 in the House 72-13 in the Senate. The bill addresses GSE regulatory reform, FHA modernization, mortgage foreclosure prevention, and related tax-code changes, along with the expansion of the statutory limit on the federal debt [from \$9.8 trillion to \$10.6 trillion]. The bill will be sent to the President on Monday, July 28; Bush is expected to sign the bill into law on July 29<sup>th</sup>. The legislation also includes the recent proposals made by Treasury Secretary Henry Paulson to provide explicit government backing of Fannie Mae and Freddie Mac through the government purchase of the GSEs’ debt and equity securities if necessary to stabilize the financial markets, to prevent the disruption of the availability of mortgages in the marketplace, and protect the taxpayers. Treasury’s expanded authority, which is set to expire on December 31, 2009, are limited by the federal debt ceiling, which is increased in the

legislation. Paulson proposed these emergency provisions, after concerns that the GSEs were grossly undercapitalized [as reported by Lehman Brothers in a July 7<sup>th</sup> research report] and were technically insolvent and may require a government bailout [triggered by public remarks by William Poole, the former president of the St. Louis Federal Reserve] triggered sharp declines in Fannie Mae's and Freddie Mac's stock prices of 45% and 58%, respectively, the week of July 7<sup>th</sup>.

- Under H.R. 3221, the Treasury Secretary must take into consideration six factors in connection with exercising this authority:
  - the need for preferences or priorities regarding payments to the government;
  - limits on maturity or disposition of obligations or securities to be purchased;
  - the GSE's plan for the orderly resumption of private market funding or capital market access;
  - the probability of the GSEs fulfilling the terms of any such obligation or other security, including repayment;
  - the need to maintain the GSE's status as a private company; and
  - restrictions on the use of GSE resources, including limitations on the payment of dividends and executive compensation.
  
- Under the emergency provisions, the Treasury Secretary may exercise any rights received in connection with the purchase of stock, and freely sell any stock, subject to the terms of the securities and at prices determined by the Secretary. According to CBO's analysis of the Treasury proposal, there is a better than 50% chance that Treasury's emergency authority would not be used before it expires at the end of 2009. For budgeting purposes, CBO estimated the cost to taxpayers at \$25 billion in 2009 and 2010.
  
- H.R. 3221 abolishes OFHEO and the Federal Housing Finance Board and creates a single housing GSE regulator, the Federal Housing Finance Agency (FHFA), which will be independently funded through assessments of the GSEs and will no longer be subject to the annual appropriations process. The FHFA will be run by director, who will be appointed by the President and confirmed by the Senate to serve a five-year term, and three deputy directors, who will be appointed by the director. A five-member Housing Finance Oversight Board will be comprised of the agency's director [who will serve as board chairman], the Secretaries of Treasury, and HUD [or their designees], and two members appointed by the president and confirmed by the Senate to advise the director on overall strategies and policies. However, the board does not have the authority to approve or disapprove decisions or actions of the director.
  
- H.R. 3221 repeals the current law giving the president authority to appoint directors to the boards of Fannie Mae and Freddie Mac and reduces the GSEs' number of board members from 18 to 13. The legislation also alters the housing missions of Fannie Mae and Freddie Mac to meet goals to be established by FHFA for single and multi-family home purchasers in low income or very low income areas, defined at 50% of area median income (AMI), using three-year averages from the Home Mortgage Disclosure Act Data. Both GSEs would be required to serve underserved

markets, such as manufactured housing, affordable housing preservation, and rural areas. Previously, Fannie and Freddie were required to purchase mortgages for households representing three income levels, moderate income (100% AMI), low income (80% AMI) and very low income (60% AMI) and were also directed to purchase mortgages in central cities, rural areas, and other underserved housing areas. FHFA may also establish housing goals for the FHLBs, after taking into account the structural and overall mission differences between the FHLBs and the GSEs.

- The new GSE regulator's primary duties will include (1) overseeing the operations of Fannie Mae, Freddie Mac, and the FHLBs; (2) ensuring that each enterprise maintains adequate capital and internal controls; (3) fostering a healthy national housing finance market that minimizes the cost of housing finance; (4) ensuring that each entity complies with applicable regulations; and (5) assuming certain oversight duties previously performed by HUD.
- The legislation requires FHFA to establish regulatory standards to measure the portfolio holdings of Fannie and Freddie with the goal of safe and sound operations for the GSEs, which factor in (1) the size and growth of the mortgage market; (2) the need for the portfolio to maintain liquidity or stability of the secondary mortgage market; (3) the liquidity needs of Fannie Mae and Freddie Mac; and (4) any other factors regulator might determine to be appropriate. FHFA could require Fannie Mae and Freddie Mac to dispose of or acquire any asset that it determines to be inconsistent "with the purpose of this Act." H.R. 3221 provides the FHFA the authority to place Fannie Mae and Freddie Mac into conservatorship or receivership and initiate corrective actions in the event of a financial crisis. Under the legislation, FHFA also would have the authority to (1) reject any acquisition or transfer of a controlling interest of the GSE; (2) adjust risk-based capital standards; (3) adjust minimum capital levels on a permanent or temporary six-month basis; (4) establish capital or reserve requirements for specific programs or activities; (5) take enforcement actions; (6) prohibit or withhold executive compensation for wrongdoing; and (7) review the reasonability and comparability of the GSEs' compensation of their executive officers. The GSEs must notify FHFA of any planned new activity. The regulator also would review and approve the GSEs' new programs within 30 days of a public comment period.
- Until December 31, 2009, FHFA will be required to consult with the Federal Reserve before issuing any proposed or final regulations, orders, or guidelines regarding prudent management, safe and sound operations, and capital requirements and portfolio standards at the GSEs.
- H.R. 3321 authorizes FHFA to establish a capital classification system for Fannie Mae and Freddie Mac similar to prompt corrective action, using the classifications (1) adequately capitalized, (2) undercapitalized, which triggers a monitoring process by the agency, development of capital restoration plans by the GSE, and possible operational restrictions on the GSE by FHFA; (3) significantly undercapitalized, which mandates a new election for a board of directors and selection of executives by

the enterprise and restrictions on payment of bonuses or increased salaries to the GSE's executives unless approved by the agency; and (4) critically undercapitalized, which triggers the establishment of a conservatorship or receivership to reorganize, rehabilitate or close the entity by FHFA and possible revocation of the GSE's charter. Regulated entities also are required to register at least one class of stock with the SEC and disclose their income and charitable contributions as reported to the IRS.

- H.R. 3221 authorizes the conforming loan limit to increase to the lesser of 125% of an area's median price or \$625,000. The loan limit would be allowed to increase in markets where the median house price exceeds the general conforming loan limit—but can not exceed 75% of the area's median home price. Under the legislation, FHFA will adjust the conforming loan limit annually, based upon its annual housing index.
- A provision of H.R. 3221 requires each GSE to establish an office of minority and women inclusion, which will implement standards for inclusion of women and minorities in all of the GSE's business activities and contracts. Each GSE will provide FHFA data to determine if disparities exist with regard to interest rates charged on mortgages to minority and non-minority for borrowers with similar creditworthiness. If disparities in mortgage interest rates are identified, FHFA will (1) refer the preliminary finding to the appropriate regulatory or enforcement agency for further review; (2) require the GSE to submit additional data; and (3) require the GSE to take remedial actions. FHFA is also required to submit to House and Senate committees a report summarizing the actions taken or being taken with regard to these findings [without disclosing the name(s) of the lenders until the matter has been adjudicated.]
- Provisions related to the FHLB System include: (1) a reducing in the number of directors for the FHLBs from 14 to 13; (2) allowing independent directors to be selected based upon the demographic make-up of the communities “most served;” (3) permitting two or more FHLBs to establish a joint office; (4) permitting the mergers of FHLBs, subject to the approval of the Banks' board of directors and the FHFA; (5) requiring the new regulator to develop regulations that ensure the FHLB System have access to the information needed to determine their joint and severable liability; and (6) lifting the cap on the Banks' director compensation and extending their terms to four years.
- The HOPE for Homeowners Act of 2008 establishes a new FHA program that would guarantee up to \$300 billion of loans used for refinancing at-risk mortgages into viable mortgages for a three year period, ending September 30, 2011. To qualify to participate in the program, all subordinated liens must be extinguished through negotiations with the first lien holder. Borrowers will be required to share the equity and appreciation equally with HUD, until the borrower sells or refinances the mortgage. If there is an equity gain on the property within the first five years of the mortgage, HUD is entitled proportionately on a sliding scale from 100% to 60% of the appreciation. Loan servicers are encouraged to participate in the new program

through the bill's safe harbor protections. The bill also provides additional protections for members of the military returning from active duty abroad by authorizing a temporary increase in the maximum loan guarantee by the Secretary of Veterans Affairs. The FHA modernization provisions also provide an increase in loan limits of FHA-insured loans, an increase in loan limits in high cost real estate markets, an extension of the term of FHA single-family loans from 35 years to 40 years; an authorization for FHA to vary insurance premiums charged to borrowers based upon their credit risk; and a modification of disclosure requirements. Under H.R. 3221, sellers or other third parties, other than family members, will not be allowed to loan funds to the homebuyer for use as their downpayment for an FHA loan.

- H.R. 3221 also includes the provisions of the Mortgage Disclosure Improvement Act of 2008, which amends the Truth in Lending Act (TILA) to expand the types of loans subject to early disclosure and improve loan disclosures provided at origination and refinancing. Under these provisions, mortgage terms would have to be disclosed at least seven days before closing, while changed terms would have to be disclosed at least three days before closing. Under the bill, fines for TILA violations will increase from \$2,000 to \$4,000 per violation.
- The legislation's tax provisions would reduce government revenue by approximately \$15.1 billion over ten years. Specifically, the bill will create a \$7,500 credit for first-time home buyers, which will serve as an interest-free loan that will be repaid over 15 years [for a cost of \$4.85 billion]. H.R. 3221 also provides a standard deduction for property taxes of up to \$500 for single filers and \$1,000 for joint filers [cost of \$1.5 billion]. The legislation also includes a temporary increase in low-income housing tax credits; an authorization of an additional \$11 billion in tax exempt bonds which can be used to finance new mortgages, finance low-income housing, and refinance certain subprime loans. Provisions also change tax incentives in the Gulf Coast regions affected by hurricanes Katrina, Rita, and Wilma, and helps some companies that cannot obtain bonus depreciation under the Economic Stimulus Act to instead use certain stored-up tax credits. The provisions also permit municipal bonds that are issued by state and local governments and guaranteed by the FHLBs to be treated as tax-exempt bonds from the period of enactment until January 1, 2011 [cost of \$126 million]. H.R. 3221's revenue provisions, intended to offset the cost of the above-described tax break, totaling \$18.55 billion over ten years, include requirements for reporting information by credit and debit card companies and third-party transactions to the IRS [\$9.5 billion revenue]; a two-year delay of a rule that would have taken effect in 2009 regarding how multinational companies allocate their interest expenses between their U.S. and foreign sources [\$7.6 billion]; and a modification of the rules governing tax gains from a principal residence [\$1.4 billion].
- H.R. 3221 includes \$3.92 billion community development block grants for the purchase and rehabilitation of foreclosed properties. The funds will be allocated to state and local governments based upon a funding formula to be developed by HUD, which factors in the demonstrated number and percentage of home foreclosures in the

state; homes financed by a subprime mortgages in the state; and homes in default or delinquency in each state or locality.

- A provision establishes the Nationwide Mortgage Licensing System and Registry (NMLSR), which will license and register individual mortgage brokers and register bank employees who originate mortgages. All applicants to the NMLSR must provide finger prints and a description of their personal history and experience, and meet a minimum set of standards to receive a license. Applicants cannot have been convicted of a felony during the previous seven years, must demonstrate their financial responsibility, and have completed their pre-licensing education requirements. (*CQ House Action Reports No. 110-39*, 07/22/08; *Financial Services and Products Advisory*, Alston & Bird LLP, 07/23/08; *Reuters*, 07/24/08; *Bloomberg News*, Alison Vekshin and Brian Faler, 07/26/08; *Bloomberg News*, Alison Vekshin, 07/27/08)
- “It is unfortunate that it took the near collapse of Fannie Mae and Freddie Mac to convince a number of my colleagues that these entities do indeed pose a systemic risk to the U.S. and global economies,” said Senator Richard Shelby (R-AL) in a July 23<sup>rd</sup> statement. “Nevertheless, I am pleased that this legislation now acknowledges and addresses that reality in statute by giving the Federal Reserve a role in advising the new regulator on risks to our financial system. Although the Fed’s role is temporary, it is now well established that the systemic risks the GSEs pose are permanent. That debate is over. The only question now is to whom the Congress assigns that responsibility in eighteen months...” (*Press Release by Senators Chris Dodd and Richard Shelby*, 07/23/08)
- “This legislation will not perform miracles. I want the American people to have realistic expectations about what we’re about to do,” said Senate Banking Committee chairman Chris Dodd (D-CT). “But as others have said, it is a step, and an important step, towards putting our nation on the road to economic recovery.” Jared Bernstein, a senior economist at the Economic Policy Institute, said, “This is not the end of the housing crunch. Housing prices have already fallen 15% and they need to fall [an additional] 10%. This bill isn’t going to change that equation.” Bernstein added, “If we’re lucky enough to help 400,000 households [through H.R. 3221], I’m afraid it’s a drop in the bucket.” Even if the FHA refinancing program [in H.R. 3221] works, its goals are modest compared with the scope of the problem, said Mark Zandi, chief economist for Moody’s Economy.com, who estimates that 5.5 million loans will default by the end of 2009 of which roughly half will go into foreclosure. (*Washington Post*, Lori Montgomery and Paul Kane, 07/27/08)
- In a July 26<sup>th</sup> news conference after the Senate passed H.R. 3221, Dodd said he is “terribly disappointed” that HUD Secretary Steve Preston has said it would take as long as a year to implement regulations to provide help for almost 400,000 homeowners at risk of foreclosure. “We wrote this legislation specifically to bypass the normal rulemaking process,” said Dodd. On July 29<sup>th</sup>, Dodd will meet with the leaders of HUD, the Federal Reserve, the FDIC, and Treasury Department, so they

can “tell me why they can’t begin immediately to get this bill working.” (*Bloomberg News*, Alison Vekshin, 07/26/08)

- Members of Congress are also stepping up the pressure on loan servicers to increase their efforts to work with troubled borrowers. Representative Barney Frank (D-MA) urged mortgage servicers to hold off on foreclosure actions “so borrowers can take advantage of the [FHA foreclosure prevention] program,” which doesn’t go into effect until October 1<sup>st</sup>. At a June 25<sup>th</sup> committee hearing, Frank, along with Representatives Maxine Waters (D-CA) and Melvin Watt (D-NC), voiced skepticism about the ability of current voluntary homeowner relief programs to stem the growing tide of foreclosures. Consumer advocate Julie Gordon of the Center for Responsible Lending said CRL supports legislative proposals that would require servicers to reduce the principal of outstanding mortgage balances in some circumstances and create a foreclosure “timeout” and mandate court-supervised loan modifications in some circumstances. “Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, voluntary efforts by lenders, servicers, and investors have failed to stem the tide of foreclosures,” said Gordon. (*National Mortgage News Mortgagewire*, 07/25/08)

Just how “temporary” will the federal government’s explicit guarantee of the GSEs be?

- Despite assurances from Treasury Secretary Henry Paulson, a growing number of skeptics on Capitol Hill and Wall Street expect the Secretary to use his authority to bail out Fannie Mae and Freddie Mac and many argue, that once it’s used, it’ll be hard to phase out. Lawrence White, professor at New York University’s Stern School of Business, said, “It will be hard [to phase out the guarantee]. It will probably require explicit legislation by the end of ‘09 to do whatever the Congress and the new administration sees fit to do. Without legislation, my guess is...the explicit guarantee will remain in place.” Representative Tom Price (R-GA) questions how the authority can be rescinded. “There will be an argument that if we don’t continue this authority, then markets will [shudder] and shake, so I believe this will be permanent.” (*American Banker*, Cheyenne Hopkins, 07/24/08)

Congress gives Fannie and Freddie a “get out of jail free” card – and sticks the tab to the taxpayers

- Congress has given Fannie Mae and Freddie Mac a “get out of jail free” card, passing legislation that authorizes the Treasury Department to bail out the GSEs without any conditions or restrictions—sending GSEs’ shares soaring to twice their levels of July 15<sup>th</sup>. H.R. 3221 doesn’t require Fannie and Freddie to eliminate or reduce their dividends, should the companies draw on their line of credit with the federal government. Treasury can’t mandate that the GSEs raise additional capital. And should Treasury purchase GSE preferred shares, the taxpayers’ investment doesn’t get seniority over other holders. Joshua Rosner, managing director of Graham Fisher & Co., also argued that taxpayers shouldn’t be forced to help pay dividends to Fannie

and Freddie stockholders or to help settle likely shareholder lawsuits against the companies.

- “It sounds like the GSEs got what they wanted again,” said Paul Miller, an analyst with Friedman Billings Ramsey. “They got a big backstop and they got language that the Treasury doesn’t necessarily have to stop them from paying dividends or cap compensation. That’s why the stocks are ripping.” H.R. 3221 codifies the GSEs’ business model, which gives Fannie’s and Freddie’s shareholders all the profits and the U.S taxpayers all the risk and resulting losses of approximately \$25 billion [according to CBO’s “rough” estimate]. (*BusinessWeek*, 07/24/08; *Washington Times*, Patrice Hill, 07/23/08)
- As part conduit, part hedge fund, and part bond insurer, the GSEs and their nearly \$6 trillion in obligations have basically been nationalized—yet the private management teams and private shareholders of these GSEs still have the power to do great harm to the housing market and the American taxpayer. (*Institutional Risk Analyst*, 07/21/08)
- With regard to CBO’s estimate of the cost of the GSE bailout, Joseph Mason wrote, “...With normal correlations, the CBO estimates the bailout will cost the Treasury (i.e., taxpayers) zero, because no bailout is given. If a crisis occurs (or continues) the CBO estimates the program could cost well over \$100 billion. The \$25 billion published in the press is, in statistical terms, an expected value. Expected values are obtained by multiplying the probability of a scenario by the payout in that scenario. For instance, in a coin flip where you get \$1 if it is heads and pay \$1 if it is tails, the expected value is  $\frac{1}{2} * \$1 + \frac{1}{2} * -\$1 = \$0$ . But you never actually get a \$0 outcome: you either get \$1 or you pay \$1. That is the statistical fallacy of the \$25 billion number: the payout will either be well in excess of \$100 billion or zero. The \$25 billion expected value does not actually occur.”
- “So when [Senator] Jim DeMint [(R-SC)] was quoted in today’s *Wall Street Journal* as calling the plan a ‘huge gamble,’ adding, ‘It’s kind of: guarantee a little now or pay a whole lot later,’ he was playing into the statistical fallacy. Add to the expected payout the effects of crony capitalism-inflated moral hazard and the payout will probably be much larger than any CBO estimate considered. Think of this plan as just forbearance in the biggest thrift crisis failure ever, and remember what happened then as thrifts dug themselves deeper into insolvency by making more risky investments in their bids for resurrection. In the words of Kevin Dowd, ‘Good statistics does not always lead to good risk management, and good risk management can be based on very bad statistics.’” (*Mason Market Commentary*, Joseph Mason, 07/23/08)
- In the *Telegraph* [UK], Ambrose Evans- Pritchard wrote, “...No doubt the rescue of Fannie Mae and Freddie Mac—[the] \$5.3 trillion pillars of America’s mortgage market—stinks of moral hazard. The Treasury is to buy shares: the Fed has opened its window yet wider. Risks have been socialized. Any rewards will go to capitalists.” (*Telegraph* [UK], Ambrose Evans- Pritchard, 07/21/08)

- In the July 25<sup>th</sup> issue of *U.S. News & World Report*, Mortimer B. Zuckerman wrote, “[Fannie & Freddie], along with Wall Street and home builders, staved off proper regulations [for the GSEs] by hiring political elites and lobbyists from both parties. They should have raised more equity but preferred higher profits per share. Their senior officers have made millions of dollars from their shareholdings. They are the winners. Now the losers will be we, the taxpayers, because F&F are too big to fail. The bailout legislation provides for more oversight, but it must be through a regulator with real teeth. It would be unconscionable for Congress to bail them out without making sure that this dangerous aunt and uncle will hereafter be restrained for the public good.” (*U.S. News & World Report*, Mortimer B. Zuckerman, 07/25/08)
- In a July 24<sup>th</sup> editorial, the *Wall Street Journal* wrote, “[T]he kid-glove treatment of Fannie Mae and Freddie Mac is very much worth worrying about. On the floor of the House..., Democrats argued that this bill was the least Congress could do ‘for the people,’ given the way the government had ‘helped’ Bear Stearns. The cost borne by Bear Stearns was having its shareholders all but wiped out and half its employees pink-slipped. Countrywide was likewise sold at a fire sale price. Not so these two government-chartered giants.”
- “Fannie and Freddie may well be too big to fail, as Treasury Secretary Hank Paulson keeps reminding us. That is true in large part because they were allowed—no, encouraged—to grow like Topsy while Congress shielded them from oversight. At a minimum, the cost of a lifeline ought to include some accountability and assurance they cannot get into such a fix again. Instead what we have is a promise that Fannie and Freddie will pay us Tuesday for an explicit taxpayer guarantee today. The Treasury will get unlimited authority to recapitalize the mortgage giants, effective immediately, while a new regulator will have to run a gauntlet of confirmation and Congressional hazing over the companies’ portfolios of mortgage securities the way a Supreme Court nominee has to handle *Roe v. Wade*.”
- “This delay will give Fannie and Freddie time to consolidate their political position and fend off attempts to shrink them to a less risky size. At the same time, the \$600 million ‘affordable housing’ fund that the bill would skin off the hide of the two firms gives Washington a permanent stake in preserving their dominant market position. If Fannie and Freddie can’t be brought to heel politically now, when weeks ago their very survival was in doubt, not even a newly empowered regulator will have any hope of reducing their claims on the public fisc once the dust settles.”
- “Mr. Paulson might have kept an eye on the taxpayer’s interest here by insisting that any money put into the companies come with some upside, as the Chrysler bailout in 1979 did. Instead we are left to trust that Mr. Paulson or his successor will have the political nerve to resist the companies and their friends on Capitol Hill. Any money given to Fannie and Freddie should have been conditioned on receivership, including clearing out the management and boards that made this mess.” (*Wall Street Journal*, 07/24/08)

### What *should* be done with Fannie and Freddie?

- In a July 27<sup>th</sup> *New York Times* editorial, William Poole, former president of the St. Louis Fed wrote, “Critics of the Congressional housing package complain that we are now committing taxpayers to huge new outlays to rescue Fannie Mae and Freddie Mac. That view is wrong: Congressional inaction over the past 15 years had already committed taxpayers to the bailout.”
- “Congress could and should have required Fannie and Freddie — which enjoy a peculiar and highly advantageous status as quasi-public agencies and quasi-private companies — to maintain more capital, but didn’t. Now the costs from Congressional inaction are becoming painfully apparent, and they cannot be avoided. To permit the two mortgage giants to default would set off a worldwide crisis. But we can decide what should become of Freddie and Fannie after this crisis. The best option is one getting little mention in Washington: get rid of them.”
- “Because the government cannot permit Fannie and Freddie to default, their obligations are part and parcel of the full-faith-and-credit obligations of the United States. Thus, the national debt, usually viewed as the \$5 trillion held by the public, is really \$10 trillion once we add the Fannie and Freddie obligations and the mortgage-backed securities they guarantee. For now, the Congressional Budget Office has entered a ‘place holder’ of \$25 billion to cover the bailout costs over the next two years but recognizes that this is a guess. The important issue is not the 2009 outlay, but the total that will be required eventually. Even if the two firms are technically insolvent, the market will continue to buy their obligations readily, for it understands that they are fully backed by the government.”
- “Given this faith on the part of the marketplace, there will be no immediate catastrophe that would force the federal government to provide additional capital to Fannie and Freddie. The situation is similar to the one in the 1980s, when many savings and loans were technically insolvent yet had no difficulty attracting deposits, as they were covered by federal deposit insurance. So the federal government has the option of delaying any ultimate resolution of the Fannie-Freddie mess, as it did with the savings and loans 20 years ago, in hopes that the two giants can dig themselves out of the hole. Still, it seems more likely that — again, just as in the 1980s — the longer we delay, the higher the eventual taxpayer cost will be.
- “Freddie Mac, according to its own fair-value accounts for the end of March, is technically insolvent — the estimated market value of its liabilities is greater than the estimated market value of its assets. Fannie Mae has a small positive net worth. In coming quarters, these figures may deteriorate because of accounting adjustments (some of the assets are questionable) and continuing defaults on mortgages. The eventual losses could run to several hundred billion dollars.”

- “Whatever the amount of the bailout, even if ‘only’ \$25 billion, the real question is not immediate survival of the loan giants but their long-term future. Instead of being regarded as too big to fail, we should look at them as too big to liquidate quickly. Fannie Mae and Freddie Mac are not essential to the mortgage market; if they were put out of business in an orderly fashion over 5 to 10 years, the market would pick up the business they abandon. Fannie and Freddie exist to provide guarantees for mortgage-backed securities trading in the market. The business is simply insurance.”
- “There are lots of insurance businesses around: property, auto, life and many others. These markets work fine without any government-sponsored enterprises. They are not highly concentrated into a small number of dominant players whose failure would threaten the entire economy; rather, lots of companies compete and spread the risk. Indeed, there are well-established firms in mortgage insurance, but their growth has been stunted by the special advantages Fannie and Freddie enjoy.”
- “In fact, there has already been a test case for how the mortgage market would function without Fannie and Freddie. After an accounting scandal in 2005, regulators severely constrained their activities. The nation’s total residential mortgage debt outstanding rose by \$1.176 trillion in that year, even though Fannie’s and Freddie’s stakes rose by only \$169 billion, just 14.4 percent of the total. In essence, the market barely noticed that the two agencies’ private competitors were providing 85 percent of the increase in mortgage debt in 2005.”
- “There are more general economic reasons for liquidating Fannie and Freddie, the biggest being that it is very dangerous to maintain such a large role in any market for only two operators. Markets work best when numerous firms compete against each other.”
- “And then there is moral hazard. Knowing they had a federal backstop, Fannie and Freddie held too little capital and the market financed their activities at interest rates very close to those enjoyed by the government. Now we are living through the result. Does it make sense to reconstitute them so that they can engage in a repeat performance?”
- “Some believe that tighter regulation is the answer. I am skeptical of that because I know the extent to which the regulatory system is tied up in Fannie’s and Freddie’s political activities. I find it deeply troubling that Fannie and Freddie, essentially in receivership to the secretary of the Treasury today, continue to employ lobbyists and hand out campaign contributions to influence the legislative debate over their own futures. Fannie and Freddie paid out more than \$170 million to lobbyists over the last decade — more than General Electric spent. Government departments cannot hire lobbyists or give money to campaigns — why should Fannie and Freddie, now wards of the government, be permitted to do so?”
- “The long-term health of the mortgage market is too important to be left to only two firms. If Fannie Mae and Freddie Mac can survive as vigorous competitors without

the special government privileges they've long enjoyed, fine. But if they insist on coming back to life as public-private hybrids with all sorts of unfair federal advantages, we'll only be setting ourselves up for more disasters. The wisest move, in the end, is to carefully let them wither away." (*New York Times*, William Poole, 07/27/08)

### Do we need Fannie and Freddie at all?

- In a July 15<sup>th</sup> editorial, the *Financial Times* wrote, "...[O]ne question that the [U.S.] government must answer as soon as possible is what role the government would like the GSEs to fulfill in the long term. The current structure for Fannie and Freddie is unsustainable. The GSEs are poorly regulated. They have given successive U.S. governments an incentive to keep the housing market inflated. They socialize their risks and privatize their profits. Having saved the GSEs this weekend, policymakers should aim to bring about a decent burial for Freddie and Fannie."
- "They could be broken up into small pieces and privatized. A rump could be retained by the Treasury as a small counter-cyclical mortgage liquidity vehicle. The process might involve a period of nationalization. This could mean the GSEs' vast debts would be moved on to the public balance sheet. However, this is unimportant. It would be a cosmetic change; the government is already backing them; it is absurd that they are not now on the books. US policymakers will be tempted to put off decisions about the future of the GSEs. However, political will for reform can often be achieved only in a crisis. It is time to correct an anomaly that has long distorted the US housing market." (*Financial Times*, 07/15/08)
- In a July 28<sup>th</sup> article in *The New Yorker*, James Surowiecki wrote, "...Whatever their sins, Fannie and Freddie clearly couldn't be allowed to fail, but that's no argument for letting them go on as they are. Either they should be forced to make it as private companies or they should be nationalized. Given that their business depends on the promise of government assistance and that their current state remains woeful (despite an upturn in their fortunes late last week), nationalization seems more sensible. If Fannie and Freddie are going to run up a tab and stick taxpayers with the bill, why should shareholders profit?"
- "Beyond that question, though, is a more important one: Do we need Fannie and Freddie at all? Their supposed reason for being is that their ability to borrow money at low rates lowers borrowing costs for homeowners. But a paper by the economist Wayne Passmore, of the Federal Reserve, suggests that in fact Fannie and Freddie have only a small effect on the interest rates that homeowners pay, saving them less than one-tenth of a percentage point. More important, if the last few years have taught us anything, it's that homeownership is not an unalloyed economic good, and that we should be cautious about using gimmicks to make it more attractive. The government already offers homeowners a subsidy, in the form of a mortgage tax break. Given everything else we could be spending taxpayer money on, does the government really need to be in the mortgage-buying business, too?" (*The New Yorker*, James Surowiecki, 07/28/08)

- In a July 22<sup>nd</sup> commentary in the *Wall Street Journal*, Al Hubbard and Noam Neusner addressed how the U.S. government should support housing finance in the long run. The authors wrote, "...When the crisis is over, will we want or need Fannie Mae and Freddie Mac? ...Here is one simple idea: Help the home buyer, not the home financing process. Don't hide a housing subsidy by outsourcing government policy to a semi-private, for-profit corporation that exposes the taxpayers to \$5 trillion in potential liabilities. If Congress wants to further subsidize homeownership beyond the already expensive mortgage interest deduction (something we think is unwise), let it create a tax credit to allow buyers to reduce the borrowing rate for the life of the loan. That credit, if set to equal 10 basis points of the total mortgage rate, would be worth \$400 a year on a \$400,000 loan, about equal to what Fannie and Freddie provide indirectly to homeowners, and with considerably less noise and risk."
- "Even if this tax credit were capped so it does not become a subsidy for buyers of million-dollar homes, it would still be expensive, costing as much as \$40 billion over 10 years. Indeed, compared with other taxpayer priorities, it may be too expensive. But it would still be less expensive than the bailout of Fannie and Freddie is likely to be, and at least it would be out there in the open, not hidden in the complicated workings of unaccountable companies."
- "If policy makers decide there is a better way to deliver a housing subsidy than through Fannie and Freddie, then the companies should be gradually totally privatized, with no government guarantee or other special privileges. And in order to make sure they are no longer too big to fail, we should consider breaking them up. Our guess is that the market will do that work in any case, because private financial institutions without government guarantees will provide the liquidity to the mortgage market that Fannie and Freddie have provided in the past."
- "...Ultimately, Congress needs to focus on how much taxpayer funds to devote to subsidizing mortgages. Whatever that decision is, it should be done in an open, honest and accountable way. The current system with Fannie and Freddie is inefficient, opaque and fraught with hidden risk for taxpayers. Clearly this is a system that requires more than modest reforms and tweaking. It needs to be replaced." (*Wall Street Journal*, Al Hubbard and Noam Neusner, 07/22/08)
- In the July 28<sup>th</sup> edition of *Weekly Standard*, Lawrence B. Lindsey wrote, "...The key to repairing the GSEs is to make sure that existing shareholders and management pay a price if they get bailed out. Ideally common shareholders should see the values of their shares reduced to zero, or close to zero. Investors in other parts of the capital structure who knew they were taking risks should have their investments written down—taking a 'haircut' in Wall Street parlance. But the bondholders, who supply the capital to homeowners, should be largely protected."
- "Government investment in the capital structure gives government control. We should avail ourselves of this opportunity to wind down the scale and scope of the government's involvement in the mortgage market. While mortgage securitization

might at one time have been a specialized ‘high tech’ financial innovation needing the government, it is not today. Homeowners, investors, and taxpayers would all benefit from having a more competitive mortgage securitization market with many well-capitalized private participants who are responsive to market discipline. The market share of Fannie and Freddie needs to be reduced...” (*Weekly Standard*, Lawrence B. Lindsey, 07/28/08)

- In a July 25<sup>th</sup> *Forbes* commentary, Steve Forbes urged the Bush administration to “vigorously push to have Fannie and Freddie recapitalized and broken up into 10 to 12 new companies, with their ties to the government completely severed.” Forbes acknowledged that taking such steps would require the federal government to inject perhaps \$300 billion in equity capital and assume some \$100 billion of questionable mortgages. “But such an investment would enable these companies to have a sound debt-to-equity ratio in the vicinity of 4-to-1. Shares in Fannie and Freddie would then be exchanged for shares of common and preferred stock in the new, solvent firms. Current shareholders could ultimately recover their losses, and taxpayers could eventually get most, if not all, of their money back. In fact, Uncle Sam might even make a profit.”
- Forbes, continued, “One part of the restructuring should mandate that the federal government sell off its equity within, say, a five-year period. Having 10 to 12 sound private companies competing in the mortgage market will help revive and reinvigorate that sector. If the Federal Reserve ever learned central banking—i.e., making the dollar strong and stable—the housing market would quickly snap back.” (*Forbes*, Steve Forbes, 07/25/08)
- In a July 25<sup>th</sup> *American Banker* article, Thomas Stanton wrote, “...It would be folly to rely largely on Fannie and Freddie to support the mortgage market over the next few years. They should not be encouraged to grow further just because they are the only source of government backing. We need alternatives without the shareholder base that creates so many perverse incentives for the GSEs. We can reduce our dependence on the GSEs. First, they should be limited to funding mortgages through securitization, rather than by building large portfolios, which are a major source of financial risk... Second, the Federal Reserve could review the multiple linkages between the GSEs and the rest of the financial markets and make recommendations to limit or end many of them.”
- “Third, to shore up the mortgage market, Congress should create a wholly owned government corporation similar to Ginnie Mae, a government agency that deals in government mortgages, to guarantee pools of conventional loans. Like the Resolution Trust Corp., the government corporation created to deal with the last mortgage debacle, this facility should have a limited life — say, five years. The new facility could help assure the housing market that mortgages will be funded at reasonable cost. Taxpayer protections would come from sound underwriting standards and risk-sharing with the private sector. The new corporation could also impose protective requirements on brokers and other originators that seek to benefit

from the facility. New mortgages in particular, based on appraisals that reflect declining home values, are likely good long-term investments. The funding facility might also fund pools of high-quality mortgages from faltering institutions such as Fannie and Freddie that lack the balance sheets to sustain them. The mortgage-funding facility offers one way to smooth the transition from today's concentration of risk in Fannie and Freddie. Once the market has stabilized and investors again are ready to put their money into the American Dream, the facility can be ended."

- "Finally, after a reasonable transition period, the shareholder-owned GSEs should be ended as an institutional form. Only when companies in the mortgage market operate under comparable capital and supervisory requirements can risk be diversified, rather than concentrated in two privileged companies that persist in keeping their capital cushions small. If today's disparities continue, then when the GSEs are propped up, their shareholders again will press for high leverage and excessive growth."  
(*American Banker*, Thomas H. Stanton, 07/25/08)
- In a July 15<sup>th</sup> post on his blog, Robert Reich wrote, "Socialized capitalism of the sort the Fed and the Treasury are now practicing, consisting of private gains and public losses, is untenable. On the other hand, it's also true that giant Wall Street investment banks as well as Fannie Mae and Freddie Mac are too big to fail. How to reconcile these conflicting principles? Here's a modest proposal: When taxpayers insure a giant entity against loss—as we now are with Freddie, Fannie, and Wall Street investment banks—those entities must agree that: (1) for the duration of the bailout, their top executives cannot receive total annual compensation higher than that received by the President of the United States, and (2) the government gets five percent of their current valuation as shares of stock (roughly representing the benefit to their shareholders of the federal insurance)—so that if and when the entities become profitable again, taxpayers are compensated for the risk they've taken on."  
(*Robert Reich's Blog*, Robert Reich, 07/15/08)
- In a July 24<sup>th</sup> editorial, the *Financial Times* wrote, "...[I]n the long run, the worst outcome may be that the Treasury gets away with [doubling down its GSE gamble], and the GSEs survive as they are. The moral hazard in granting these weakly regulated pseudo-private entities an unlimited guarantee has been raised to a new and extreme point. In the end, Fannie and Freddie should either be dismantled or brought within the public sector. Emboldened evasion of that unpalatable choice will increase the final cost to taxpayers, to say nothing of the collateral damage along the way."  
(*Financial Times*, 07/24/08)

#### Unintended consequences?

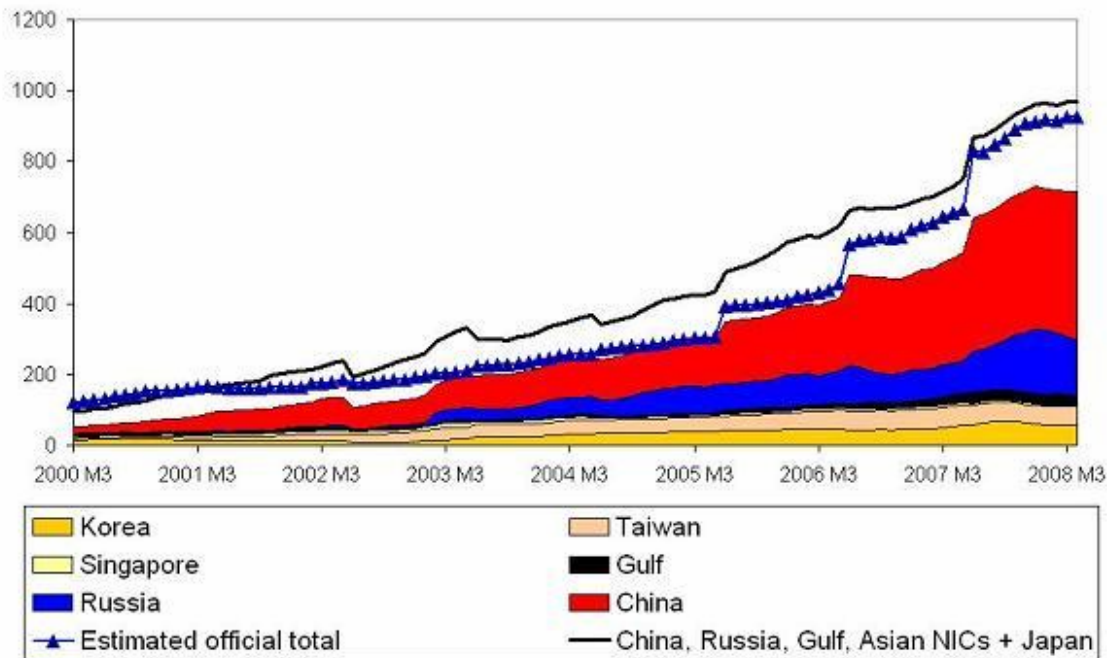
- In a July 24<sup>th</sup> post on *Competitive Enterprise Institute's OpenMarket.org*, John Berlau wrote, "Of all the unintended consequences of the housing bill [H.R. 3221] that passed the House yesterday — of which there will likely be many — one of the most ironic and far-reaching may be this: that whatever security marginal homeowners

have from foreclosures, their homes will be far less safe from being taken by a bureaucrat through eminent domain. That's because the bill unveiled this week — as the result of negotiations between House Financial Services Committee Chairman Barney Frank and Treasury Secretary Hank Paulson — takes specific language protecting property rights from the housing bill that most recently passed the Senate and renders it almost meaningless. As a result, the billions of dollar in new grants the bill provides for 'the production, preservation and rehabilitation' of housing units, could stimulate a bonanza of state and local property of the type green-lighted in the Supreme Court's 5-4 decision *Kelo v. New London*. That 5-4 decision in 2005 allowed states and localities to use eminent domain for the benefit of private parties, so long the land confiscation served a 'public purpose...'"

- “To their credit, the drafters of the Housing and Economic Recovery Act of 2008, which passed the Senate on July 11, at least recognized this danger of throwing billions in construction grants to state and local governments. So they put in a clause stating, ‘No funds under this title may be used in conjunction with property taken by eminent domain, unless eminent domain is employed for a public use.’ The clause then adds that ‘public use shall not be construed to include economic development that primarily benefits any private entity.’ But this language has vanished from the House bill that passed yesterday, replaced with phrasing that at first glance may seem similar but would give governments substantially more leeway to take land. The nearly 700-page bill craftily replaces the Senate’s prohibition on funds ‘used in conjunction with property taken by eminent domain’ with a looser ban on using the funds for a ‘project that seeks to use the power of eminent domain.’”
- “This new language in the House bill would give property-grabbing bureaucrats an easy way around the supposed prohibition on using eminent domain. All they would have to do is take property for any reason that *Kelo* allows, and then come up with another project for the specific use of that property. If land were grabbed for general economic development, as *Kelo* permits, and then a new project were created for a city to sell this land to developers, this would likely not be a violation of the House bill. After all, the new project isn’t ‘seeking’ to use eminent domain, it is merely using land that had already been confiscated. It is typical for governments to many times change the ‘project’ or purpose of land use once it has been taken through eminent domain...”
- “...How did these property rights protections get removed? That’s somewhat of a mystery. ...This slighting of property rights from the earlier Senate bill cannot be ignored. Otherwise, the US may repeat the tragedy of ‘50s and ‘60s ‘urban renewal,’ where the ‘federal bulldozer’ of government housing programs literally made people homeless. (*Competitive Enterprise Institute’s OpenMarket.org*, John Berlau, 07/24/08)

## Who are we bailing out?

### Agency holdings by country



- Answer: China, Russia, Singapore, Korea, Japan, Taiwan...  
(<http://blogs.cfr.org/setser/files/2008/07/agencies-8.JPG>)

## How did we get in this mess?

- In a July 22<sup>nd</sup> editorial, Thomas Sowell, senior fellow with the Hoover Institution, wrote, “In one of those front-page editorials disguised as ‘news’ stories, the *New York Times* blames ‘the lucrative lending practices’ of banks and other financial institutions for helping create the current financial crisis of millions of borrowers and of the financial system in general. It must take either a willful determination to believe whatever they want to believe or a cynical desire to propagandize their readers for the *New York Times* to call ‘lucrative’ the lending practices that have caused many lenders to lose millions of dollars, some to lose billions and some to go bankrupt themselves.”
- “Blaming the lenders is the party line of Congressional Democrats as well. What we need is more government regulation of lenders, they say, to protect the innocent borrowers from ‘predatory’ lending practices. Before going further down that road, it may be useful to look back at what got us into this mess in the first place.”

- “It was not that many years ago when there was moral outrage ringing throughout the media because lenders were reluctant to lend in certain neighborhoods and because banks did not approve mortgage loan applications from blacks as often as they approved mortgage loan applications from whites. All this was an opening salvo in a campaign to get Congress to pass laws forcing lenders to lend to people they would not otherwise lend to and in places where they would not otherwise put their money.”
- “The practice of not lending in some neighborhoods was demonized as ‘redlining’ and the fact that minority applicants were approved for mortgages only 72 percent of the time, while whites were approved 89 percent, was called ‘overwhelming’ evidence of discrimination by the *Washington Post*. Some people are more easily overwhelmed than others, especially when they find statistics that seem to fit their preconceptions. But if we do what politicians and the media seldom bother to do—stop and think—an entirely different picture emerges.”
- “In our own personal lives, common sense leads us to avoid some neighborhoods. If you want to call that ‘redlining,’ so be it. But places where it is dangerous to go are often also places where it is dangerous to send your money. As for racial differences in mortgage loan application approval rates, that does not tell you much if you are comparing apples and oranges. Income, credit history and net worth are just some of the things that are very different from one group to another.”
- “More important, in the same ways that blacks differ from whites, whites differ from Asian Americans. The fact that whites are turned down for conventional mortgage loans, and resort to subprime loans, more often than Asian Americans do is seldom reported in ‘news’ stories about lending practices, even though such data are readily available. Shocking as it may be to some, lenders are in the business of making money, and they don’t much care whose money it is, so long as they get paid.”
- “Politicians, on the other hand, are in the business of getting votes, and they don’t much care whose votes it is—or what they have to say or do in order to get those votes. It was government intervention in the financial markets, which is now supposed to save the situation that created the problem in the first place. Laws and regulations pressured lending institutions to lend to people that they were not lending to, given the economic realities. The Community Reinvestment Act forced them to lend in places where they did not want to send their money, and where neither they nor the politicians wanted to walk.”
- “Now that this whole situation has blown up in everybody’s face, the government intervention that brought on this disaster in is supposed to save the day. Politics is largely the process of taking credit and putting the blame on others-- regardless of what the facts may be. Politicians get away with this to the extent that we gullibly accept their words and look to them as political messiahs.”  
([www.realclearpolitics.com](http://www.realclearpolitics.com), Thomas Sowell, 07/27/08)

- In *Forbes*, Yaron Brook, managing director of BH Equity Research and executive director of the Ayn Rand Institute, wrote, "...There has been no free market in housing or finance. Government has long exercised massive control over the housing and financial markets—including its creation of Fannie Mae and Freddie Mac (which have now amassed \$5 trillion in liabilities)—leading to many of the problems being blamed on the free market today....The government has promoted bad loans not just through the stick of the CRA but through the carrot of Fannie Mae and Freddie Mac, which purchase, securitize and guarantee loans made by lenders and whose debt is itself implicitly guaranteed by the federal government. This setup created an easy, artificial profit opportunity for lenders to wrap up bundles of subprime loans and sell them to a government-backed buyer whose primary mandate was to ‘promote homeownership,’ not to apply sound lending standards. ... Given that our government was behind the wheel, influencing every aspect of the mortgage crisis, it is absurd to call today’s situation the result of insufficient regulation. We do not need more regulation or economic ‘steering’—laws or bureaucrats dictating to financiers and investors the kind of innovation they may or may not engage in. If that were the solution to economic problems, then Hugo Chavez would preside over the world’s healthiest economy in Venezuela. What we need to do is remove the government’s power to coerce, bribe, reward and bail out irrational decisions. The unfree market has failed. It’s time for a truly free market.” (*Baron’s*, Yaron Brook, 07/18/08)

#### Time to pull the plug on the Fannie Mae and Freddie Mac charade

- In a July 12<sup>th</sup> commentary in *Financial Times*, Dr. Willem Buiter, Professor of European Political Economy, London School of Economics and Political Science, wrote, “Are Fannie Mae and Freddie Mac adequately capitalized, as asserted recently by US Treasury Secretary Hank Paulson, Federal Reserve Board Chairman Ben Bernanke and their regulator Office of Federal Housing Enterprise Oversight Director James B. Lockhart III? The answer is: **obviously not**, if these two government-sponsored enterprises of the US federal government had to make a living on normal private commercial terms. **Obviously not** if they were subject to the market discipline preached by Paulson and Bernanke, but not practiced when it comes to large financial institutions perceived as systemically important (too large or too interconnected to fail) or too politically sensitive to fail.....”
- “There are many forms of socialism. The version practiced in the U.S. is the most deceitful one I know. An honest, courageous socialist government would say: this is a worthwhile social purpose (financing home ownership, helping my friends on Wall Street); therefore I am going to subsidize it; and here are the additional taxes (or cuts in other public spending) to finance it. Instead the dishonest, spineless socialist policy makers in successive Democratic and Republican administrations have systematically tried to hide both the subsidies and size and distribution of the incremental fiscal burden associated with the provision of these subsidies, behind an endless array of opaque arrangements and institutions. Off-balance-sheet vehicles

and off-budget financing were the bread and butter of the US federal government long before they became popular in Wall Street...”

- “The financial assistance offered to U.S. homeowners through the spaghetti of federal financial inducements (ranging from the tax deductibility of nominal interest payments to the subsidization of mortgage financing provided by the FHA and the GSEs) is not primarily socialism for the rich. It is socialism for the electorally sensitive, rather like the agricultural welfare state that exists in the U.S.”
- “So let’s call a spade a bloody shovel: nationalize Freddie Mac and Fannie Mae. They should never have been privatized in the first place. Cost the exercise. Increase taxes or cut other public spending to finance the exercise. But stop pretending. Stop lying about the financial viability of institutions designed to hand out subsidies to favored constituencies. These GSEs were designed to make losses. They are expected to make losses. If they don’t make losses they are not serving their political purpose.”
- “... I call on Secretary Paulson, Chairman Bernanke and Director Lockhart to drop the market-friendly fig-leaf. Be a socialist and proud of it. Come out of the red closet. The Soviet Union may have collapsed, but the cause of socialism is alive and well in the USA. Granted, the U.S. version of socialism is imperfect thus far. The federal authorities have mainly intervened to socialize the losses in the financial sector while allowing the profits to continue to be drained off into selected private pockets. But that is bound to be an oversight. It surely cannot be the intention of such committed Marxists to target taxpayer-funded largesse solely at the very rich and at a few favored, electorally sensitive constituencies. Fannie and Freddie are, or will be, safe in the hands of comrades Paulson, Bernanke and Lockhart [and Congress].” (*Financial Times*, Dr. Willem Buiter, 07/12/08)
- In a July 27<sup>th</sup> editorial, the *Washington Post* wrote, “...Readers of these editorials are familiar by now with our concerns about Fannie Mae and Freddie Mac: profit-seeking entities fueled by preferential access to capital markets, they have exposed the federal taxpayer to immense mortgage-related risk. This risk no longer seems quite justified by the two entities’ contribution to reducing mortgage rates. Under any sensible scenario, the firms will have to be made more sustainable—which is to say, smaller. Also central to federal housing policy is the mortgage interest tax deduction, which will be worth \$100 billion to homeowners in fiscal 2009, according to the government. Upper-income homeowners living in relatively expensive homes reap most of the benefit. Shrinking the deduction, or phasing it out altogether, would remove this distortion.”
- “Indeed, the mortgage interest deduction illustrates another persistent problem of federal housing policy: one program often contributes to a problem that other programs try to solve. Does the mortgage interest deduction divert resources from modest to expensive housing? If yes, the FHA must work that much harder to make housing affordable through guaranteed loans. Or Congress feels obliged to create an

affordable housing trust fund, as it is doing in the latest legislation. Of course, that will be funded by Fannie and Freddie, which means they have fewer resources for making mortgages cheaper. At one time, many thought that securitized subprime mortgages could help close the affordability gap, especially for minorities; loose federal [and state] regulation fostered such mortgages, with consequences we all know.”

- “Federal support for housing has spawned a formidable lobby, made up of builders, bankers, real estate agents and homeowners in every congressional district. And that’s not to mention Fannie and Freddie’s influence on the Hill. Taking them on will be no easy task. Yet, sooner or later, it has to be done. Without a more rational, efficient and equitable housing policy, future generations may well find it harder to realize the American dream.” (*Washington Post*, 07/27/08)

#### The fatally flawed GSE rescue

- In a July 25<sup>th</sup> commentary in *Financial Times*, Dr. Joseph Stiglitz, chairman of Columbia University’s Committee on Global Thought and recipient of the 2001 Nobel Prize for economics, wrote, “Much has been made in recent years of private/public partnerships. The US government is about to embark on another example of such a partnership, in which the private sector takes the profits and the public sector bears the risk. The proposed bail-out of Fannie Mae and Freddie Mac entails the socialization of risk – with all the long-term adverse implications for moral hazard – from an administration supposedly committed to free-market principles.”
- “Defenders of the bail-out argue that these institutions are too big to be allowed to fail. If that is the case, the government had a responsibility to regulate them so that they would not fail. No insurance company would provide fire insurance without demanding adequate sprinklers; none would leave it to ‘self-regulation.’ But that is what we have done with the financial system. Even if they are too big to fail, they are not too big to be reorganized. In effect, the administration is indeed proposing a form of financial reorganization, but one that does not meet the basic tenets of what should constitute such a publicly sponsored scheme.”
- “First, it should be fully transparent, with taxpayers knowing the risks they have assumed and how much has been given to the shareholders and bondholders being bailed out. Second, there should be full accountability. Those who are responsible for the mistakes – management, shareholders and bondholders – should all bear the consequences. Taxpayers should not be asked to pony up a penny while shareholders are being protected. Finally, taxpayers should be compensated for the risks they face. The greater the risks, the greater the compensation.”
- “All of these principles were violated in the Bear Stearns bail-out. Shareholders walked away with more than \$1bn (€35m, £500m), while taxpayers still do not know the size of the risks they bear. From what can be seen, taxpayers are not receiving a cent for all this risk-bearing. Hidden in the Federal Reserve-collateralized

loans to JPMorgan that enabled it to take over Bear Stearns were almost surely interest rate and credit options worth billions of dollars. It would have been easy to design a restructuring that was more transparent and protected taxpayers' interests better, giving some compensation for their risk-bearing."

- "But the proposed bail-out of Fannie Mae and Freddie Mac makes that of Bear Stearns look like a model of good governance. It sets an example for other countries of what not to do. The same administration that failed to regulate, then seemed enthusiastic about the Bear Stearns bail-out, is now asking the American people to write a blank check. They say: 'Trust us.' Yes, we can trust the administration – to give the taxpayers another raw deal."
- "Something has to be done; on that everyone is agreed. We should begin with the core of the problem, the fact that millions of Americans were made loans beyond their ability to pay. We need to help them stay in their homes, including by converting the home mortgage deduction into a cashable tax credit and creating a homeowners' Chapter 11, an expedited way to restructure their liabilities. This will bring clarity to the capital markets – reducing uncertainty about the size of the hole in Fannie Mae's and Freddie Mac's balance sheets."
- "The government should set a limit to the size of the bail-out, at the same time making it clear that, while it will not allow Fannie Mae and Freddie Mac to fail, neither will it be extending a blank check. There may need to be a drastic reorganization. There should be a charge for the 'credit line' (any private firm would do as much) and, given the risk, it should be at a higher than normal rate."
- "The private sector knows how to protect its interests; the government should do no less. As long as the credit line is extended, no dividends should be paid. To ensure that the government is not simply bailing out creditors who failed in due diligence, at least, say, 25 percent of any notes, loans or bonds coming due that are not lent again should be set aside in an escrow account, to be paid only after it is established that taxpayers are not at risk. Any government loans should be cumulative preferred debt: the taxpayers get paid before any other creditors receive a dime. To discourage moral hazard the interest rate should be at a penalty rate and, reflecting the rising risk, increase with the amount borrowed. Finally, the government should participate in the upside potential as well as the downside risk: for instance, by taking shares (which it might later sell) or, as it did in the Chrysler bail-out, warrants."
- "We should not be worried about shareholders losing their investments. In earlier years, they were amply rewarded. The management remuneration packages that they approved were designed to encourage excessive risk-taking. They got what they asked for. Nor should we be worried about creditors losing their money. Their lack of supervision fuelled the housing bubble and we are now all paying the price. We should worry about whether there is a supply of liquidity to the housing market, so that those who wish to buy a home can get a loan. This proposal provides the necessary liquidity."

- “A basic law of economics holds that there is no such thing as a free lunch. Those in the financial market have had a sumptuous feast and the administration is now asking the taxpayer to pick up a part of the tab. We should simply say **No.**” [Emphasis added.] (*Financial Times*, Dr. Joseph Stiglitz, 07/25/08)

Mr. and Mrs. Taxpayer—Meet Fannie and Freddie...

- In a July 11<sup>th</sup> editorial, the *Financial Times* wrote, “With the price of a barrel of oil exceeding \$146 and stock markets reeling, the global economic turmoil has worsened this week. Yet most remarkable of all has been the sight of socialist turkeys coming home to roost in the US, home of free-market capitalism. These sorry birds, colloquially known as Fannie Mae and Freddie Mac, are ‘government-sponsored enterprises.’ What exactly that means, [the American taxpayers] may soon discover.” (*Financial Times*, 07/11/08)
- ‘Everyone has a neighbor who they know overdid it at some point ...who put nothing down on a house and then went out and bought a Hummer,’ said Michael Franc with the Heritage Foundation. “There’s a major element of, ‘You did it to yourself.’” Representative Randy Neugebauer (R-TX) said, “Some of these people are struggling to make their own payments, and now we’re going to transfer their neighbor’s house payment—who got in over his head—on them too?” (*Associated Press*, 07/25/08)



- In a July 25<sup>th</sup> editorial, the *Washington Post* wrote, “...Lawmakers can go home in August and tell the voters that they did something about housing. Exactly what they will have done, and at what eventual cost, may be harder to explain.” (*Washington Post*, 07/25/08)

- The following Letters to the Editor appeared in the July 28<sup>th</sup> *Wall Street Journal*:
  - Bill Connell, Florence, OR wrote: “I agree with the bailout of Freddie and Fannie, but only after firing all the officers and directors—with no severance and with no retirement benefits. They have violated the public trust and some should go to jail.”
  - James D. Senger, Bethesda, MD wrote: “Try as I might, I have never understood why a government-sponsored enterprise that enjoys all sorts of special protections and benefits should pay its executives as though they were having to function in a free market. Are the executive jobs at Fannie Mae really comparable to those at Hewlett-Packard or IBM? Are private sector salaries necessary or sensible for GSEs? I believe that dedicated and capable civil servants could manage these companies effectively, serving the public interest while avoiding the scandals and distractions we have seen over the past few years.”
  - Bob McCaffrey, Plymouth, MI wrote: “As a retired GM employee who has just lost his health-care benefits, I am neither a ‘country club Republican’ nor a ‘pseudo-capitalist.’ In reading your op-ed on the troubles at Fannie and Freddie, I lament that the saddest part of the story is that the people who back politicians like Barney Frank, Chuck Schumer, et al., will never read it. If they can't get the story in two lines or a 10-second TV sound bite, they are not interested. Guys like Franklin Raines will continue to strip this country of its wealth, unimpeded, while insisting that they are only helping the downtrodden and the little guy.” (*Wall Street Journal*, 07/28/08)

#### Take taxpayers off hook for rot at Fannie, Freddie

- In a July 23<sup>rd</sup> editorial in the *St. Petersburg Times*, Senator John McCain (R-AZ) wrote, “Americans should be outraged at the latest sweetheart deal in Washington. Congress will put U.S. taxpayers on the hook for potentially hundreds of billions of dollars to bail out Fannie Mae and Freddie Mac. It’s a tribute to what these two institutions — which most Americans have never heard of — have bought with more than \$170-million worth of lobbyists in the past decade.”
- “With combined obligations of roughly \$5-trillion, the rapid failure of Fannie and Freddie would be a threat to mortgage markets and financial markets as a whole. Because of that threat, I support taking the unfortunate but necessary steps needed to keep the financial troubles at these two companies from further squeezing American families. But let us not forget that the threat that Fannie Mae and Freddie Mac pose to financial markets is a tribute to crony capitalism that reflects the power of the Washington establishment.”
- “Fannie and Freddie buy home loans from lending institutions and reissue them as marketable securities — creating a liquid market for mortgage debt that lowers borrowing costs for prospective homeowners. The two institutions have easy access

to borrow at low interest rates because they were originally government agencies and continue to be viewed as being backed by the government. The irony is that by bailing them out, Congress is about to make that perception a reality, even though government backing is no longer needed for their original mission. There are lots of banks, savings and loans, and other financial institutions that can do this job.”

- “Fannie and Freddie are the poster children for a lack of transparency and accountability. Fannie Mae employees deliberately manipulated financial reports to trigger bonuses for senior executives. Freddie Mac manipulated its earnings by \$5-billion. They’ve misled us about their accounting, and now they are endangering financial markets. More than two years ago, I said: ‘If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose.’ Fannie and Freddie’s lobbyists succeeded; Congress failed to act. They’ve stayed in business, grown, and profited mightily by showering money on lobbyists and favors on the Washington establishment. Now the bill has come due.”
- “What should be done? We are stuck with the reality that they have grown so large that we must support Fannie Mae and Freddie Mac through the current rough spell. But if a dime of taxpayer money ends up being directly invested, the management and the board should immediately be replaced, multimillion dollar salaries should be cut, and bonuses and other compensation should be eliminated. They should cease all lobbying activities and drop all payments to outside lobbyists. And taxpayers should be first in line for any repayments.”
- “Even with those terms, sticking Main Street Americans with Wall Street’s bill is a shame on Washington. If elected, I’ll continue my crusade for the right reform of the institutions: making them go away. I will get real regulation that limits their ability to borrow, shrinks their size until they are no longer a threat to our economy, and privatizes and eliminates their links to the government.”
- “It’s time to get America on the right track by creating the jobs that will build a strong foundation under our housing markets. We need to address the high cost of gasoline and other energy sources, and transform health care to be cheaper, higher quality and built around the needs of patients. But most of all, we need to reform Washington and wrest control from the special interests that have created this problem.” (*St. Petersburg Times*, Senator John McCain, 07/23/08)

## Uncle Sam: Subprime Borrower

- In a July 26<sup>th</sup> editorial in the *Wall Street Journal*, Dr. Jonathan GS Koppell, an associate professor at the Yale School of Management, wrote, “The embrace of Fannie Mae and Freddie Mac by the federal government makes it official: Uncle Sam is the world’s foremost subprime borrower. Concern about the potential borrowing necessary to cover the two government-sponsored enterprises’ obligations even prompted speculation in the bond markets of a lowered government credit rating. How did these two companies with the funny names get us into this most unfunny mess?”
- “Not all by themselves, of course. Congress and the president are the primary culprits. And although the profligate spending of the federal government is obviously an issue, that is not the subject here. The root cause of the whole Fannie/Freddie mess is Congress’s destructive unwillingness to treat risk seriously. There have been warnings about potential future liability associated with the ballooning balance sheets of these firms, which carry the implicit guarantee of the federal government. But these warnings have been largely ignored.”
- :Should we really be surprised? For Congress, scouring the budget for funding that will take care of current needs (urgent or not) is hard. Turning a blind eye to an increasingly gargantuan *potential* liability is easy. Fannie and Freddie are a congressional dream come true. They offer a real benefit of central importance to millions of Americans, and they are completely free! At least that is how it felt until now.”
- “And it gets even better. Like the oxymoronic ‘off-balance-sheet liabilities’ that are plaguing the most hallowed names in American finance, the liabilities of the GSEs are off-budget. They don’t count because the two companies are owned by shareholders, not the government. Indeed, one of the principal motives for the federal government selling Fannie Mae in 1968 was to move it off-budget. The peculiar status of the GSEs allows everyone to simply wish the liability away.”
- “All one needs to do to understand the source of the problem is look at the bill likely headed to the president soon. In one remarkable piece of legislation, Congress has both provided the Treasury Secretary with government-financed life preservers to be used if the two companies are drowning, and also increased their borrowing powers, enabling them to purchase more and bigger mortgages than before. The House version calls for an assessment on Fannie and Freddie that would finance an affordable-housing fund and cover cost overruns of the Federal Housing Administration foreclosure bailout program. In other words, Fannie and Freddie are being encouraged to head for the deep end of the pool even as we wring our hands about their ability to swim.”

- “How does this continue to happen? The S&L crisis of the 1980s showed that ‘costless’ guarantees can turn into real on-budget expenditures—more than \$120 billion worth at that time. That chastened Congress, and led to the creation of a financial regulator for Fannie and Freddie with modest bite. But the years pass, the memories fade and all that ‘free’ public policy is sitting right there for Congress's taking, like a freshly-baked pie temptingly perched on a window sill.”
- “The management of the enterprises urges Congress to take the pie because more pie is more business, higher returns to shareholders, and rising stock prices. All the housing-related industries from mortgage brokers to realtors to construction companies to Wall Street financiers push along too. More loans equal more business. The housing advocates join the chorus. Grab the pie, they say. More loans—provided they go to underserved communities—means more units to be built for their constituencies (and, not coincidentally, the voters in each member's district).”
- “And who is urging restraint, warning of the potential consequences of taking the pie, cautioning against allowing these two private companies to create obligations with the implicit backing of the U.S. government? No one. There is no constituency for prudence, no well-financed interest group to mobilize voters in the name of American creditworthiness. It isn't even a fair fight.”
- “Congress is not the only institution challenged by the management of risk. The whole financial crisis can be seen as the product of individuals and institutions discounting risk. From the homebuyer who agreed to an interest-only loan, assuming that the appreciation in two years would allow a painless refinance, to the highly leveraged financial institution that put itself at the mercy of unknown counterparties, each player either discounted or wished away the risk associated with their actions.”
- “Some kind of intervention in this case is good public policy. Allowing Fannie and Freddie to falter—with the collapse of the global economy as a plausible side effect—would be an act of dubious risk management in itself. Moving forward, however, we need to ask whether Congress is capable of utilizing these powerful instruments responsibly. The regulatory reforms included in the bill may bulk up the enterprises' oversight. But they do not alter the essential dynamic described here.”
- “The current situation shows just how ingenious and useful the GSEs can be. The creditworthiness of the federal government is employed to prod the market in socially valuable directions. But when the use of this tool endangers the very creditworthiness it relies upon, one must contemplate putting this invaluable tool behind glass, to be used only in the event of an emergency.”
- “There are many proposals to fundamentally alter the relationship between the federal government and the GSEs. The current crisis opens a window of opportunity to make a change. Sadly, Congress seems to see it as an invitation to grab more pie.” (*Wall Street Journal*, Dr. Jonathan GS Koppell, 07/28/08)

S&P announces possible downgrade of the GSEs' subordinated debt and preferred stock

- Standard & Poor's announced it may downgrade Fannie Mae's and Freddie Mac's \$19.2 billion of subordinated bonds and the GSEs' \$26 of billion preferred stock, but affirmed the AAA ratings on the companies' senior debt with a stable outlook. As a result of the rating agency's announcement, the cost to protect the GSEs' bonds from default rose, while the value of the GSEs' preferred shares traded lower. S&P analyst Victoria Wagner said that the Housing and Economic Recovery Act of 2008 leaves it up to the Treasury Secretary to decide whether to honor preferred dividend payments or to repay subordinated bondholders before the government, casting an "ambiguity" over the securities. After S&P analysts have fully analyzed the final legislation, the ratings may be cut one or two levels, said Wagner. "We had factored in some federal support for these securities, but now I think the financial risks are now outweighing support and have to be reflected in the rating."
- Fannie Mae's and Freddie Mac's common shares are down more than 70% in 2008, closing at \$11.55 and \$8.27, respectively on July 25<sup>th</sup>. The plunge in the GSEs' stocks is "adding to the already-stressed business cycle," which may make it difficult for the companies to raise capital, said Wagner. "We feel that given the changing market dynamics and the changing legislation landscape, that that heightened risk should be more of a factor in our current [rating]." (*Bloomberg News*, Dawn Kopecki and Shannon D. Harrington, 07/25/08)

SEC issues emergency order prohibiting naked short selling  
of securities for 19 major financial companies

- On July 18<sup>th</sup>, the SEC issued an emergency rule that temporarily prohibits the naked short selling in securities of 19 major financial companies, which included Fannie Mae, Freddie Mac and 17 financial firms. The rule, which requires any person effecting a short sale of the listed securities to borrow the security before the short sale is effected and to deliver the securities on the settlement sale, will be in effect for ten days and may be extended to 30 days. SEC chairman Chris Cox said the SEC will need to do an interim final rule for the rule to be effective beyond 30 days, which is his agency's intention he said in testimony before the Senate Banking Committee. Cox told lawmakers that the SEC will start a rulemaking focusing not only on the primary dealers and the GSEs, but also on the "broader market." He also testified that his agency has more than four dozen law enforcement investigations pending in the subprime prime area, which includes subprime lenders, investment banks, credit rating agencies and others involved in the securitization process, and banks and broker-dealers who sold MBS to the public. (*Bureau of National Affairs*, Yin Wilczek, 07/16/08; *Wall Street Journal*, Kara Scannell and Jenny Strasburg, 07/16/08)

- On July 11<sup>th</sup>, IndyMac Bank, F.S.B was placed into conservatorship by FDIC, making the California thrift the nation’s second largest bank failure in history and likely the most expensive. The \$32 billion thrift—with about \$1 billion in uninsured deposits—is expected to cost the FDIC between \$4 and \$8 billion or nearly 25% of IndyMac’s total assets. The IndyMac failure is expected to absorb upward of 15% of the FDIC’s \$53 billion of insurance reserves and will likely result in an increase in deposit insurance premiums to 10 to 15 basis points from the 5 to 7 basis points paid by banks today. In a public statement, FDIC said that it would initially cover half of IndyMac’s uninsured deposits and reassured the public that their “insured money is safe.” On July 11<sup>th</sup>, the FHLB-San Francisco had outstanding advances to the Bank of \$10.1 billion, which “remain fully secure” by approximately \$21.6 billion in mortgages and mortgage-backed securities from IndyMac.
- OTS director John Reich said that the release of a letter by Senator Charles Schumer (D-NY) questioning the solvency of IndyMac was “the immediate cause” of the bank’s failure, which triggered a \$1.7 billion run on deposits. Schumer responded by saying, “If OTS had done its job as regulator and not let IndyMac’s poor and loose underwriting practices continue, we wouldn’t be where we are today. Instead of pointing false fingers of blame, OTS should start doing its job to prevent future IndyMacs.”
- In a July 15<sup>th</sup> editorial, the *Wall Street Journal* wrote, “...Senator Chuck Schumer, who helped to precipitate the collapse [of IndyMac] by publicizing [his] letter to the bank’s regulator last month, has no remorse. He was, he says, just doing his job in telling regulators that the bank ‘could face a collapse,’ a prophecy that quickly proved to be self-fulfilling. ‘It’s what legislators are supposed to do,’ the New York Democrat told the *Journal*. Depositors who spent Monday trying to recover some of their money might beg to differ. ... But Mr. Schumer was not content merely to share his profound concern with regulators. He also leaked the June 26 letter to the press – which is more like shouting ‘fire’ in a crowded bank than dialing 911.”
- In the July 14<sup>th</sup> issue of *Institutional Risk Analyst*, Chris Whalen wrote, “This morning Americans should be very grateful to the dedicated professionals at the FDIC and OTS who handled this difficult process [of IndyMac’s failure]. We should also heap steaming piles of radioactive scorn on Senator Charles Schumer (D-NY) for his bombastic statements prior to IndyMac’s failure [which triggered a \$1.3 billion run on the bank]. Schumer’s selfish actions deserve censure by the Senate.” Lawrence B. Lindsey added, “...[W]e need to put financial regulation out of the reach of politicians seeking time before the television cameras. Bank supervision works only when it is done quietly, letting the regulator and the bank solve problems out of the glare of the limelight. Senators should not be spreading panic for political gain.” (*Bureau of National Affairs*, Thecla Fabian, 07/14/08; *American Banker*, Joe Adler, 07/15/08; *Wall Street Journal*, Dwight Cass and Antony Currie, 07/16/08; *Reuters*, 07/13/08; *FHLB-San Francisco Press Release*, 07/11/08; *American Banker*, Joe

Adler, 07/16/08; *The Institutional Risk Analyst*, Chris Whalen, 07/17/08; *Frontline Weekly Newsletter*, John Mauldin, 07/12/08; *Weekly Standard*, Lawrence B. Lindsey, 07/28/08; *Wall Street Journal*, 07/15/08; *HousingWire*, Paul Jackson, 07/11/08)

- On July 25<sup>th</sup>, FDIC took over the \$3.6 billion First National Bank Holding Company with its two bank subsidiaries, 1<sup>st</sup> National Bank of Nevada and First Heritage Bank, and sold the company's branches to Mutual of Omaha Bank, which purchased \$200 million of the bank's assets and paid a 4.41% deposit premium for the bank's deposits. FDIC estimates that the cost of the First National Bank Holding Company failure to be \$862 million (*Associated Press*, 07/26/08; *Reuters*, 07/26/08)

Freddie Mac completes its registration with the SEC and announces plans to raise capital
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- On July 18<sup>th</sup>, Freddie Mac received approval to register with the SEC, clearing the path for the company to proceed with a \$5.5 billion capital raise it had promised its regulator in May. [On the day of this announcement, Freddie's market capitalization was only \$5.9 billion—down from \$22.2 billion on December 31, 2007.] Freddie Mac spokesman Michael Cosgrove said the company plans to complete its capital raise in one or more offerings, which will include common and preferred capital securities. "We continue to review and consider alternatives for managing our capital, including issuing equity in amounts that could be substantial, reducing our common dividend and limiting the growth or reducing the size of our retained portfolio," said Freddie. The *Wall Street Journal* reported that Freddie Mac might try to raise as much as \$10 billion of capital to investors, but company spokeswoman Sharon J. McHale called \$10 billion figure "speculation." (*Washington Post*, Jeffrey H. Birnbaum and Lori Montgomery, 07/19/08; *New York Times*, Vikas Bajaj, 07/19/08)
- In its filing with the SEC, Freddie Mac disclosed that their board of directors increased the compensation of CEO Richard Syron 24% to \$18.3 million in FY2007, as its shares plunged 50% in value and the company reported aggregate losses of \$4.5 billion in the third and fourth quarters the year. Syron's pay package included a base salary of \$1.2 million; bonuses of \$3.45 million; stock awards of \$8.66 million, and additional options to purchase \$3.37 million of additional stock, according to Freddie Mac's 2007 proxy statement. [In contrast, Fannie Mae increased the compensation package to CEO Daniel Mudd only 3.2% to \$11.6 million.]
- Freddie Mac's disclosure of Syron's compensation has triggered harsh criticism on Capitol Hill and on main street. During a floor debate of H.R.3221, Senator Chuck Hagel (R-NE), "I would like to know why taxpayers should extend Fannie and Freddie an unlimited line of credit at a time when their stock and investor confidence has fallen precipitously and their CEOs continue to make multi-million dollar salaries and bonuses?" [A provision was added to the legislation which gives the GSE regulator the authority to review the compensation of the GSEs' executives to ensure it doesn't exceed industry standards.] The GSEs' crisis is as frustrating as the royal

treatment of their CEOs, say some Wall Street analysts. “That is the most outrageous of the current financial disasters,” well-known bank analyst Richard Bove with Ladenburg Thalmann. The crisis was caused solely by “mismanagement, for the purpose of massive personal aggrandizement,” said Thalmann. “It’s an outrage. What worries me is the complete lack of accountability by Fannie’s and Freddie’s executives” and investment bankers who stand to gain from a government bailout, said former Clinton administration Labor secretary Robert Reich. “We’ve created the worst form of socialized capitalism, private gains combined with public losses.” (*Bloomberg News*, Dawn Kopecki, 07/21/08; *Fortune*, Colin Barr, 07/18/08; *ABC News*, Justin Rood, 07/21/08)

- Freddie Mac also announced it will release its second quarter results on August 9<sup>th</sup>, prior to the NYSE market open and will hold an investor conference call at 10 a.m. to discuss the company’s financial performance. (*Freddie Mac Press Release*, 07/23/08)

## ***Fannie Mae and Freddie Mac***

Pay to play
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- On *Politico.com*, Lisa Lerer reported, “If you want to know how Fannie Mae and Freddie Mac have survived scandal and crisis, consider this: Over the past decade, they have spent nearly \$200 million on lobbying and campaign contributions. But the political tentacles of the mortgage giants extend far beyond their checkbooks. The two government-chartered companies run a highly sophisticated lobbying operation, with deep-pocketed lobbyists in Washington and scores of local Fannie- and Freddie-sponsored homeowner groups ready to pressure lawmakers back home.”
- “...So far this election cycle, Freddie Mac’s political action committee and employees have contributed \$555,567 to Senate and House candidates, and Fannie Mae’s PAC and employees have given more than \$1.1 million, according to the Center for Responsive Politics. In total, the two companies have spent \$170 million on lobbying over the past decade, according to the Center, although they have scaled back in recent years. Last year, they paid \$14.1 million in lobbying fees, a significant decrease from a high of more than \$26 million in 2004. ([www.Politico.com](http://www.Politico.com), Lisa Lerer, 07/16/08)
- *Washington Post Sleuth Blog* reports, “Fannie Mae and Freddie Mac plan to let loose and forget about their troubles at this summer’s Democratic and Republican national conventions, while plying their congressional critics with champagne and hors d’oeuvres. While congress considers a taxpayer-funded rescue plan, the twin

mortgage giants are planning to host receptions in Denver, where Democrats will hold their convention beginning Aug. 28, and in Minneapolis-St. Paul, where Republicans will gather a week later. ‘Building stable communities for America’s future,’ reads the invitation to join Fannie and Freddie for a ‘housing industry open house reception’ at the posh Graves Hotel in Minneapolis, which is listed as one of the ‘gold list reserve top hotels in the world’ by *Conde Nast Traveler* magazine. ‘More than 400 expected to attend,’ the invitation promises. (The planned parties are especially ironic given that both the Denver and Minneapolis metropolitan areas have been plagued with record numbers of foreclosures.)”

- “Word of the Fannie-Freddie party isn’t going over so well with conservatives on Capitol Hill... one of the toughest and most vocal critics of the proposed rescue plan, doesn’t sound too enthusiastic about attending the housing industry bash in Minneapolis. “Fannie and Freddie should focus on opening the doors to home-ownership, not the doors to swanky lobbyist parties with politicians,” says [Senator Jim] DeMint’s (R-SC), spokesman Wesley Denton. “If Americans are being forced to bail them out, they should learn to buy drinks on their own dime, not the taxpayers’.” DeMint said Thursday that “if American taxpayers are forced to [bail out] Fannie Mae and Freddie Mac, their lobbying and political activities should stop.”
- “But the housing industry party in Minneapolis is one big lobbying cabal. Fannie and Freddie are co-hosting the party with the National Association of Home Builders, the Independent Community Bankers of America and the National Association of Realtors. A Fannie Mae spokeswoman told us late Thursday afternoon that since it was ‘after five’ she wouldn’t be able to provide comment on whether the mortgage lender will still throw its receptions at the conventions. We hope to get a response today -- before cocktail hour begins, of course.” (*Washington Post Sleuth Blog*, Mary Ann Akers, 07/18/08)

Fannie and Freddie may record more losses, says OFHEO
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- In its 2007 report on the mortgage market, OFHEO said Fannie Mae and Freddie Mac may need to record more writedowns on their \$217 billion of non-agency MBS portfolios, which are falling as other financial firms write down their holdings. “To the extent that those institutions recognize fair value losses on their private-label portfolios under GAAP, Fannie Mae and Freddie Mac may have to do so as well,” said OFHEO. On December 31<sup>st</sup>, privately-issued securities backed by subprime mortgages and Alt-A mortgages comprised 9.2% and 5.8%, respectively, of the GSEs’ combined portfolio, said OFHEO. In 2004 and 2005, the GSEs invested “heavily” in private-label securities, which “significantly increased their exposure to fair value losses from changes in market prices,” said the regulator. (*Bloomberg News*, Dawn Kopecki, 07/22/08)
- Separately, OFHEO announced that bank examiners from the Federal Reserve and Comptroller of the Currency working with the GSEs’ regulator to asses the financial

condition of the GSEs. In light of the GSEs' recent market turmoil, OFHEO director James B. Lockhart, III said that increased sharing of information among regulators is "prudent." In an interview with reporters and editors of the *New York Times*, Treasury Secretary Henry Paulson said he expected the conclusion of the examination by the banking regulators would provide an important signal of confidence in the markets. "OFHEO has told us one thing [that the GSEs have enough capital to withstand further losses] and the markets have told us another," said Paulson. "I'd like as much input as possible." The examinations would "make the markets more comfortable" with the financial condition of the GSEs, he added. (*New York Times*, Stephen Labaton, 7/22/08; *Wall Street Journal*, James R. Hagerty, 07/22/08)

- In a July 23<sup>rd</sup> interview with *Bloomberg News*, OFHEO director James B. Lockhart said, "[Fannie and Freddie] are adequately capitalized according to law. Many argue that the law is weak. We need to look at how you build up rainy day capital in these two companies so they can cope with these kinds of markets. We need to figure out how we can do that in the future, how they can have excess capital in the future." Lockhart added that the new GSE regulator, created under H.R. 3221, will take months to revise the GSEs' capital rules. "We need to do a much better job [under H.R. 3221's provisions] than the present law," said Lockhart. (*Bloomberg News*, Peter Cook and Dawn Kopecki, 07/23/08)

Fannie and Freddie's foreclosed homes totaled \$8.56 billion on March 31<sup>st</sup>

- According to regulator filings, Fannie Mae acquired twice as many homes through foreclosure during the first quarter as it sold, which may weigh on the company's stock [which lost almost half its value since June 5], said Moshe Orenbuch, managing director of equity research at Credit Suisse Group AG. On March 31<sup>st</sup>, Fannie Mae and Freddie Mac owned a record \$6.9 billion of foreclosed homes, compared with \$8.56 billion held by all 8,500 U.S. commercial banks and savings and loans. According to Lehman Brothers' economists Ethan Harris and Michelle Meyer, foreclosed houses sell at an average discount of about 20%. At that rate, Fannie and Freddie stand to lose \$1.39 billion on the foreclosed houses they currently own. (*Bloomberg News*, Bob Ivry and Sharon L. Lynch, 07/23/08)

Federal Reserve issues final rules to protect mortgage customers

- The Federal Reserve Board has adopted a final rule to protect mortgage customers from unsafe and deceptive lending and advertising practices under the Home Ownership and Equity protection act, which amends Regulation Z. Under the rule, lenders will not be able to make high-risk loans without assuring that the borrowers can prepay them. Lenders will be required to verify the borrowers' income and assets and will be mandated to maintain escrows for first-lien mortgages. The rule also establishes a definition of "higher priced mortgage loans"—mortgages whose APR exceeds the "average prime offer rate" by 1.5% or more for first liens and 3.5% or

more for subordinate-lien loans—and sets forth separate rules for these mortgages. Those provisions include (1) prohibiting a lender from making a loan without regard to the borrower’s ability to repay the loan from the borrower’s income and assets other than the home; (2) prohibiting a lender from relying on income or assets that it does not independently verify to determine repayment ability; (3) banning prepayment penalties [with certain exceptions]; and (4) requiring the establishment of an escrow account [which can be cancelled after one year].

- For all closed-end loans, the rule (1) prohibits certain servicing practices, such as failing to credit a payment to a borrower’s account as of the day the payment was received, failing to provide payoff statements within a reasonable period of time, and “pyramiding” late fees; (2) prohibits a lender or broker from coercing or encouraging an appraiser to misrepresent the value of the home; and (3) requires the lender to provide a good faith estimate of the loan costs within three days after the loan application for any closed-end mortgage loan secured by the applicant’s principal dwelling for purchase money, refinance and home improvement loans. The rule also requires that advertisements contain additional information about rates, monthly payments and other loan features and ban seven advertising practices.
- The Federal Reserve withdrew its proposed rules regarding yield-spread premiums, broker disclosures and servicing fee disclosures, but expressed its intent to continue reviewing the YSP and broker disclosure issues. With the exception of the escrow requirements, the new rules apply to all mortgage loan applications received on or after October 1, 2008. The effective date for the escrow provisions has an effect date of April 1, 2010 for site-built homes and October 1, 2010 for manufactured homes. (*Consumer Financial Services Alert*, Goodwin Procter, LLP, 07/15/08; *Bureau of National Affairs*, 07/15/08)

#### Subprime and beyond...

- On July 22<sup>nd</sup>, OFHEO said that US housing prices fell 0.3% on a seasonally adjusted basis in May for a 4.8% decline over the last 12 months based upon the agency’s monthly housing index. Five out of the nine census divisions also experienced drops in housing prices with the prices in the South Atlantic division decreasing the most-- 1.2%, followed by the West South Central region (declining 1%), and the New England, East South Central, and Mountain regions (with declines of less than 1%). However, prices of homes in the Pacific region increased 0.3%, followed by the East North Central, and Middle Atlantic regions, which rose 0.1%. (*Bureau of National Affairs*, 07/23/08)
- During the second quarter of 2008, 739,714 homes received at least one foreclosure-related notice during the quarter, or one in every 171 U.S. households, according to RealtyTrac Inc. Nevada, California, Arizona, and Florida reported the highest foreclosure rates, while cities in California and Florida accounted for 16 of the worst 20 metro foreclosure rates. Stockton, CA reported the highest rate, with one in every

25 homes in the town receiving a foreclosure filing—nearly seven times the national average. Economists predict that 2.5 million homes nationwide will enter the foreclosure process in 2008, up from about 1.5 million in 2007. (*Associated Press*, J.W. Elphinstone, 07/25/08)

- Moody's reports that more than two of every five subprime borrowers whose mortgages were restructured during the first half of 2007 are defaulting anyway. At least 42% of these modified mortgages were at least 90 days late on March 31<sup>st</sup>. "In all, even with the higher re-default rate, Moody's believes that the increase in proactive efforts by servicers to modify subprime loans may modestly lower cumulative losses incurred by securitization pools, wrote Moody's analyst Aashish Marfatia. (*Bloomberg News*, Jody Shenn, 07/14/08)
- Bridgewater Associates issued an "apocalyptic" warning to its clients that bank losses worldwide may reach \$1.6 trillion—more than four times official estimates—which includes \$1.1 trillion of losses that will have to be written off by institutions and insurance companies all over the developed world. As a result, banks and investment institutions may need an additional \$400 billion of capital infusions. Bridgewater also estimates that the net worth of U.S.-based assets is down 13% since January 2007 for a total of nearly \$8 trillion. In the *Frontline Weekly Newsletter*, John Mauldin wrote, "...And let me be clear. There are some very large commercial and investment banks which are simply going to be absorbed, as regulators move to keep the entire system working. Bear Stearns is not a one-off deal. I think it is likely we will see at least one European bank nationalized. Losses the size that Bridgewater describes are beyond ugly. They are life-threatening for more than one major institution..." Mauldin notes that the Fed and central banks will allow the banks to buy time over the next several years (at a minimum) to work through the additional \$1.1 trillion of problem assets that have yet to be written off. (*Frontline Weekly Newsletter*, John Mauldin, 07/12/08)
- On July 23<sup>rd</sup>, Fitch Ratings announced it had enhanced its U.S. residential mortgage loss model that it uses to assess RMBS new-issue ratings. The rating agency's revisions suggest a very bearish outlook on housing prices over the next five years. According to Fitch's report, it is expecting home prices to decline by an average of 25% in real terms at the national level over the next five years, starting from the second quarter of 2008—and that's the agency's base case scenario. "Some MSAs such as San Diego and San Francisco, CA are expected to experience home price declines by as much as 47% and 33% over the next five years, while home prices in MSAs such as San Antonio, TX are expected to appreciate by 7%," said Huxley Somerville, group managing director and head of Fitch's U.S. RMBS group. (*HousingWire*, Paul Jackson, 07/23/08)
- San Diego's City Attorney, Michael Aguirre, has filed a lawsuit Bank of America Corp and its Countrywide unit to prevent the mortgage lenders from foreclosing on homes in his city, and plans to file similar lawsuits against Washington Mutual Inc, Wells Fargo & Co, and Wachovia Corp in an effort to make the lenders negotiate

with mortgage borrowers facing foreclosure. “We would like to see San Diego become a foreclosure sanctuary,” Aguirre said. (*Reuters*, Marty Graham, 07/23/08)

- In a note to clients, Wachovia economists Mark Vitner and Adam York wrote, “It looks to us that at least one half of the peak-to-trough price decline [in real estate values] has already occurred and that we should see an outright bottom either late next year or in the first part of 2010. A reasonable first assumption is that a bigger boom will produce a bigger bust.” Looking at housing in relation to income, Vitner and York said that if prices were to moderate back to where they were relative to income in the mid and late 1990s, the S&P/Case-Shiller 20 City index would have to decline 35.1% in total compared with its 17.5% fall thus far. (*Reuters*, James Saft, 07/23/08)
- According to a new research report by *Moody’s Economy.com*, rising levels of debt coupled with falling home prices is pushing the U.S. economy to a breaking point and setting up consumers and investors for a nasty fall later this year. On June 30<sup>th</sup>, an annualized 2.72 million first mortgage loans were in default with household liabilities that were delinquent or in default totaling \$775 billion, representing 7.5% of all U.S. household debt. *CreditForecast.com* projects that defaults could hit 3 million, double the number defaults in 2007 (approximately 1.5 million) and triple the number 2006 (1 million). “Household credit quality is rapidly eroding, and overleveraged households are at the heart of the economy’s problems,” said Moody’s chief economist Mark Zandi. “The mounting losses on household debt are straining financial institutions and will keep the economy struggling to grow for the remainder of this year and well into 2009.” With national house prices now down 16% from their spring 2006 peak, Zandi estimates approximately 9.6 million U.S. homeowners now have mortgage balances that exceed the market value of their home. (*HousingWire*, Paul Jackson, 07/23/08)
- Wachovia Corp., the nation’s 14th-largest wholesale originator, reported a second quarter loss of \$8.86 billion and announced plans to close its wholesale channel and lay-off 6,250 employees and eliminate more than 4,000 unfilled positions. The bank said it will “redeploy” 1,000 mortgage workers to help Wachovia customers refinance “Pick-a-Pay” loans. The Charlotte-based bank attributed its huge losses to writedowns on its “commercial, corporate lending, and investment banking subsegments.” On July 12<sup>th</sup>, Wachovia announced that it had named Treasury Undersecretary Robert K. Steel to serve as its chief executive officer and president and that its chief financial officer, Thomas A. Wurtz, will resign as the Bank’s chief financial officer as soon as a successor is selected. (*National Mortgage News MortgageWire*, 07/22/08; *American Banker*, Lauren Pollock, 07/10/08; *American Banker*, Paul Davis, 07/25/08)
- National City Corp, one of the nation’s ten largest banks, reported a second quarter loss of a \$1.76 billion, triggered by soaring losses on mortgage and real estate construction loans and a write-down for acquisitions. Excluding the goodwill write-down, Nat City’s loss was 94 cents per share, more than quadruple the average

analyst forecast for a loss of 20 cents per share. On June 30<sup>th</sup>, the Bank was classified as “well capitalized” with a Tier-1 ratio of 11.1%, following its \$7 billion capital injection by Corsair Capital LLC (in April). “We have more than sufficient capital to ride out turbulent credit markets,” said CEO Peter Raskind. “We need to improve performance.” (*Reuters*, Jonathan Stempel, 07/22/08)

- Washington Mutual Inc, the nation’s largest thrift institution, posted a \$3.33 billion second-quarter loss, as souring mortgages forced it to set aside more money for loan losses. The thrift’s continuing losses prompted Moody’s Investors Service to say it may downgrade Washington Mutual to “junk” status. Shares of Washington Mutual fell in after-hours electronic trading. (*National Mortgage News MortgageWire*, 07/22/08)
- Second quarter earnings reported by Bank of America (\$3.4 billion), Wells Fargo (\$1.75 billion), and JPMorgan Chase (\$ 2 billion )and loss by Citigroup (\$2.5 billion), were stronger than expected by Wall Street analysts and buoyed market hopes that the market may have reached bottom. [Hope springs eternal]. (*Associated Press*, 07/16/08; *BusinessWire*, 07/17/08; *Reuters*, 07/21/08; *New York Times*, Louise Story, 07/19/08)
- Robert Kelly, CEO of Bank of New York Mellon, said, “A lot of banks and financial institutions in the industry have taken pretty tough hits to their capital accounts in the writedown of securities, and there is still more to come on loans. Loan losses are still rising in the industry and one has to think ... that credit card loans, auto loans and probably some real estate losses will occur over time as well. That still has to play out, probably at least for the rest of this year and potentially into next year as well.” BNY Mellon reported a 31% decline in second-quarter earnings from last year, as a result of charges and writedowns related to the bank’s expectation that home prices could still drop as much as 17% over the next several years, added Kelly. (*Pittsburgh Tribune Review*, Ron DaParma, 07/18/08)
- During the week of July 14<sup>th</sup>, the Mortgage Bankers Association’s refinancing index fell 5.6%, as the 30-year fixed mortgage rate jumped 37 basis points to 6.59%. Mortgage rates rose that week by nearly 40 basis points, nearing their highest level of the year and adding to pressures on an already weak housing market. (*Financial Times*, Michael Mackenzie and Nicole Bullock, 07/23/08; *Wall Street Journal*, 07/23/08)
- MGIC reported a \$97.9 million loss (or a loss of \$0.79 per diluted share) for the second quarter compared to \$76.7 million earnings (\$0.79 per diluted share) in the year-ago period. In a conference call with investors, CEO Curt Culver said MGIC would likely come in on the lower end of previous loss guidance with paid claims to come in closer to \$1.8 billion for 2008 than \$2 billion, rather than tapering off default activity. “The reality is that the change has been slowed due to the various state and lender foreclosure moratoriums, servicing delays, fraud investigations, mitigation

opportunities and a lack of capacity of our court system,” Culver added.  
(*HousingWire*, Paul Jackson, 07/18/08)

- In a conference call with investors, JP Morgan’s CEO Jamie Dimon suggested that losses in his company’s prime mortgage book could triple in the foreseeable future as the credit mess moves out of subprime and into Alt-A and jumbo loans. “Prime looks terrible,” said Dimon. “And we’re sorry, and there’s nothing else we can say.” JPMorgan currently holds \$34.4 billion of jumbo mortgages and \$2.5 billion of Alt-A mortgages. During the second quarter, the company’s net charge-offs among prime loans in the second quarter rose to \$104 million, more than double the \$50 million recorded during the first quarter. In 2007, JP Morgan jumped in headlong into jumbos and Alt-A mortgages. “We were wrong, we obviously wish we hadn’t done it,” said Dimon. “We’re very early in the loss curve.” As a result, JPMorgan reported net income of \$2 billion for the second quarter, a 53% decline from the year-ago results. (*HousingWire*, Paul Jackson, 07/17/08)
- In the *Frontline Weekly Newsletter*, John Mauldin wrote, “...[R]egulators need to move NOW to create a Credit Default Swaps Exchange. A problem/crisis in that unregulated market is actually a far bigger problem than the current subprime crisis. Why do you think Bear Stearns was not allowed to go into bankruptcy? There are banks that are too big to fail, despite what Paulson says for public consumption...” (*Frontline Weekly Newsletter*, John Mauldin, 07/12/08)
- Jonathan L. Kempner, president of the Mortgage Bankers Association, will step down at the end of the year when his contract ends, and be succeeded by John A. Courson, the former chairman of MBA, who will begin serving as the group’s COO beginning August 1<sup>st</sup>. (*Washington Post*, Jeffrey H. Birnbaum, 07/23/08)

Staffing changes in the Bush administration
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- Ken Wilson, Goldman Sach’s most senior financial institutions banker, will retire from his firm to advise Treasury Secretary Henry (Hank) Paulson on how to resolve the country’s banking crisis. Wilson, 61, is expected to serve without pay through January 2009, said sources familiar with the matter. “Hank needs help because it could still get worse,” said Wilson. (*Wall Street Journal*, Susanne Craig, 07/22/08; *Wall Street Journal*, Dennis K. Berman, 07/21/08)
- President Bush has announced his intention to nominate Anthony Ryan to serve as undersecretary of treasury of finance. Ryan, who currently serves as assistant secretary for financial markets, has been designated acting undersecretary in the interim. Ryan succeeds Robert Steel, who resigned on July 9<sup>th</sup> to become the new president and CEO of Wachovia Corp. (*Bureau of National Affairs*, 07/11/08)
- The SEC has named Wayne Strumpfer to lead the investor education unit within the agency’s Office of Investor Education. Previously, Strumpfer was the Deputy

## ***Fannie Mae***

Fannie Mae is “chock-full of true believers”—and they’re mad

- The swoon of Fannie Mae’s stock in July has triggered “intense worry” among 5,800 employees at the GSE, 4,755 of whom work in the Washington, DC area. “For the long-termers, this is just horrible,” said Thomas Lawler, Fannie Mae’s former senior vice president for portfolio management, who retired in 2006. “This is something people are just . . . their mouths are just agape. As an existing shareholder, you’re sad, depressed and possibly even [ticked] off.” Lorrie Rudin, the former director of executive compensation for Fannie Mae who retired last year, said, “This is my family’s financial future. I worked there for 20 years, and I’m just absolutely devastated and terrified.”
- In interviews with the *Washington Post*, Fannie Mae employees said that they were also upset with senior management because they have not publicly defended the firm or tried to bolster company morale more aggressively. “Coming out of an era where Fannie Mae was very aggressive with its media policy and with its congressional relations activities, I don’t understand how the current Fannie Mae management chooses not to be as aggressive in either area . . . especially when your fate is subject to political decisions,” said William R. Maloni, the former head of Fannie’s government and industry relations who retired in 2004. “You need to try and help shape those opinions through lots of direct contact and, ideally, positive media.” One “ex-senior” Fannie employee was told that there was a “raging debate” among senior management on July 10-11 about whether the company should actively defend itself. Management decided not to publicly defend the company, deciding that such an action would make the company “look weak,” said one source.
- Current and former Fannie employees now are angry at what investor perception and actions has done to their retirement funds and the public view of their companies. “It’s hard to overstate how—and I don’t mean this in a weird, Waco, Texas, kind of way—Fannie and Freddie are kind of cultish companies,” said the former senior Fannie employee. “True believers [are] gung-ho and work like crazy, and they believe in what they’re doing and believe in their companies’ mission... And Fannie is chock-full of people like that. Just chockfull of true believers.” (*Washington Post*, Christopher Twarowski, Frank Ahrens, Simone Baribeau, Thomas Heath, David S. Hilzenrath, and Anita Huslin, 07/14/08)

Former Fannie Mae chairman and CEO Raines is “taking calls” from the Obama campaign and providing advice on mortgage and housing policy issues

- On July 16<sup>th</sup>, the *Washington Post* featured an interview with former Fannie Mae chairman and CEO Franklin Raines and printed Raines’ opinion editorial entitled “The Help Fannie and Freddie Need.” In his interview, Raines remained “insistent” that Fannie’s recent problems are not rooted in the company but stem from a time when the Bush administration and the Fed insisted the government-sponsored enterprise carried no explicit federal backing.
- In his *WaPo* editorial, Raines wrote, “Don’t bail out Fannie Mae and Freddie Mac. They don’t need it. The losses they face are not surprising, given what’s happened to housing prices. They have more than enough capital to meet their cash obligations when those become due, which is the most basic definition of solvency. They also have hundreds of billions of dollars’ worth of unencumbered assets that can be used as collateral for secured borrowing, were that to become necessary. The recent Treasury proposals do not change these facts. What the companies need from Washington is policy clarity. ...President Bush should stand with Secretary Paulson, Chairman Bernanke, Fannie and Freddie’s regulator, and with the chairmen of the relevant House and Senate committees, and together they should declare Fannie and Freddie’s clear roles in our markets. They should codify this role in legislation that will bind future administrations. The sooner this happens, the better.”
- During a live chat with readers on the *Washington Times*’ website, Raines said Fannie and Freddie were unprepared for the recent plummet in home prices, which have fallen 15% on average in the past year and dropped by twice as much in parts of California, Florida, Nevada and Arizona. “Housing prices had not fallen on a nationwide basis at all since the Depression,” said Raines. “Fannie had the capital to withstand a 5 % decline but has had to raise additional capital to manage a 15% decline.”
- *Washington Post* reporter Anita Huslin noted, “[M]ore recently [Raines has] taken calls from Barack Obama’s presidential campaign seeking his advice on mortgage and housing policy matters.” (*Washington Post*, Anita Huslin, 07/16/08; *Washington Post*, Franklin Raines, 07/16/08; *Washington Times*, Patrice Hill, 07/23/08)

Fannie Mae invests \$20 billion in multifamily housing during the first six months of 2008

- Amid stress in the capital markets and a downturn in the commercial mortgage-backed securities market, Fannie Mae announced that it will expand liquidity, stability and affordability by increasing its participation in key segments of the multifamily market. The company also announced that it has invested \$20 billion in multifamily housing in the first half of 2008, demonstrating its leadership in the multifamily real estate market. “Affordable rental housing is increasingly needed

during this housing and mortgage market downturn. Fannie Mae is increasing our product offerings to provide additional liquidity to meet the changing market needs,” said Phil Weber, SVP of Multifamily at Fannie Mae. (*Fannie Mae Press Release*, 07/09/08)

## ***Freddie Mac***

Freddie Mac’s mortgage portfolio swells to \$792 billion in June

- In June, Freddie Mac’s retained mortgage portfolio swelled at an annualized rate of 33% to \$792 billion, as the company used its expanded buying power to invest \$18.6 billion in mortgage-backed securities that it guarantees. The company also reported that its purchase commitments rose to \$34.7 billion from \$26.2 billion in May. In an interview with *Bloomberg News*, Credit Suisse analyst Moshe Orenbuch said, “[Freddie’s mortgage growth is] now up to \$80 billion in growth in the quarter without raising the capital” to support those assets. Freddie will need to raise at least \$2.5 billion in capital to support its added mortgage growth volume in addition to the \$5.5 billion the company pledged to raise in May, added Orenbuch. He has argued that Freddie erred by ramping up its mortgage growth before raising capital to support the growth. “Appears to me that Freddie is trying to grow its way out of its deep hole; same strategy employed by many S&Ls in the 1980s,” said former St. Louis Federal Reserve President William Poole. “The strategy increases risk to taxpayers.”
- The credit quality of Freddie’s mortgages continued to deteriorate, as the company’s serious delinquency rate of single-family mortgages rose 7 basis points to 0.86% in May—more than double the June 2007 rate of 0.72%. (*Bloomberg News*, Dawn Kopecki, 07/25/08; *Wall Street Journal*, James R. Hagerty and Joann S. Lubin, 07/15/08)

## ***Federal Home Loan Banks***

FHLB System second quarter earnings increased 14.5%

- On June 30<sup>th</sup>, the FHLB System reported total assets of \$1.344 trillion, an increase of 5.7% since year-end 2007, while the System’s advances increased 4.4% to \$914 billion. Combined net income for the quarter was \$719 million, a 14.5% increase from the same period last year, while the System’s six month income for 2008 increased 13.4% to \$1.4 billion. The FHLBs reported total capital of \$57 billion, which represented 4.24% of the System’s total assets. (*FHLBanks Office of Finance Press Release*, 07/22/08)

The FHLBs' top 10 members held 40% of the System's advances on September 30, 2007

- In a July 2008 report entitled "Mortgage Markets and the Enterprises in 2007," OFHEO wrote, "FHLB advances grew by approximately 50 percent in the third quarter of 2007 at an annual growth rate that was almost 17 times larger than the annual growth rate in the previous quarter. That growth increased the concentration of advances among member institutions. According to the FHLB System's Combined Financial Reports, the top 10 FHLB members (in terms of advances) held 40 percent of all advances at the end of the third quarter of 2007, up from 34.9 percent at the end of the second quarter." (*Mortgage Markets and the Enterprises in 2007*, OFHEO, July 2008)

U.S. Treasury proposes to increase its authority to purchase FHLB obligations

- As part of the agency's proposal to expand its support of the housing GSEs, the U.S. Treasury announced that it will ask for Congressional approval to temporarily increase its authority to purchase FHLB obligations. "In the interest of maintaining consistency in its policies towards all GSEs, we understand that the Treasury also intends to propose expanded authority for its purchase of FHLBank obligations," said John Fisk, CEO of the FHLBanks Office of Finance, in a statement. (*FHLBanks Office of Finance Press Release*, 07/14/08)

Finance Board eases its restrictions on the FHLB-Chicago's stock redemptions

- The Federal Housing Finance Board has eased restrictions on the FHLB-Chicago pertaining to the redemption of certain stock. During a closed session on July 23rd, the Finance Board approved the Bank's request to allow the redemption of stock used to support new advance borrowings as long as capital requirements are maintained. The regulator's move could prompt the Bank's members to borrow more advances, secure in the knowledge that they can redeem their stock once the advances are repaid. The Finance Board's resolution noted that the Bank's "advance business has grown modestly since the imposition of the consent order but has not grown commensurately with the growth in advances at the other eleven Home Loan Banks." The Finance Board's decision could be its final regulatory action. (*American Banker*, Steven Sloan, 07/25/08)

FHLB-Cincinnati approves \$2.1 million in grants  
to nonprofit groups for foreclosure mitigation

- The FHLB-Cincinnati has approved 11 grants totaling \$2.1 million to nonprofit groups for foreclosure mitigation in Ohio, Kentucky, and Tennessee. The grants were awarded through the Bank's Preserving the American Dream program, in which 55 of its 726 members participated. "Through this new program, up to \$3,500 will be made available to help a homeowner receive foreclosure-prevention counseling or benefit from other foreclosure-mitigation steps," said David Hehman, CEO of the Bank. (*American Banker*, Steven Sloan, 07/22/08)

## ***Farm Credit System / Farmer Mac***

House Financial Services Committee members object to FCA's proposed rule  
that would transform the FCS into a general credit provider

- In a July 10<sup>th</sup> letter to the FCA chairman, members of the House Financial Services Committee protested the establishment of a proposed rule that would allow the Farm Credit System to finance nonagricultural businesses and activities and transform the FCS into a general credit provider, serving suburban areas in addition to farmers. "The proposed rule is contrary to congressional intent, going beyond the historical mission of the Farm Credit System into financing projects that are not related to farming," wrote the members. The letter specifically outlined three provisions of the rule which they are primarily dissatisfied with which would allow FCS members to (1) make equity investments in venture capital funds to help it provide non-agricultural financing; (2) make investments in the rural community, if they are approved by the Farm Credit Administration; and (3) make investments outside of urbanized areas as determined by the Census Bureau in the most recent U.S. census.
- Commercial bankers, who have historically opposed the expansion of the FCS, also have voiced objections to the proposed new rule. In a statement, the American Bankers Association said, "ABA member bankers, state bank associations and bankers nationwide have led a long battle to stop the expansion of the Farm Credit System's authority beyond its statutory mission and expose its Horizons project for what it was--an effort by a government sponsored enterprise to make a wide range of business loans that have no real connection to farmers or ranchers." In January 2006, the FCS introduced the Horizons project, which proposed to expand lending by the FCS to businesses outside of the agriculture sector and to allow the FCS members to invest in real estate, and called for redefining the term "rural" to include some suburban areas. Despite aggressive lobbying by the FCS, Congress did not include the Horizons' provisions in the 2008 Farm Bill. "[I]t is disturbing that the Farm

Credit Administration is now championing similar or greater expansion of the Farm Credit System through this proposed rule and others,” said the House Financial Services Committee members’ letter. (*Bureau of National Affairs*, Jewel Edwards, 07/16/08)

Farm Credit System’s total commitments to the ethanol industry totaled \$4.4 billion at year-end 2007 to fewer than 100 borrowers

- On December 31, 2007, the Farm Credit System’s total commitments to the biofuel industry totaled \$4.4 billion, representing 16.8% of the System’s capital, of which \$2.3 billion of its commitments had been funded. According to the Farm Credit Administration’s 2007 Annual Report, “[The System’s exposure to the biofuel industry] are ...relatively small numbers when compared to the System’s exposure in other areas, but these risks are spread over a relatively small number of borrowers (estimated at fewer than 100). In addition to its loan holdings in the ethanol industry, the System also originates and participates out a substantial amount of debt to non-System lenders.”
- “As we look ahead, the two most immediate concerns in the ethanol industry are the potential supply/ demand mismatch for ethanol in the Midwest—reflecting transportation infrastructure bottlenecks—and the narrow profit margins in the production facilities. The optimism about ethanol’s future belies the fact that this industry still requires large tax incentives, import protections, and mandated blending requirements to remain viable. Even if ethanol profits improve, the System will continue to face a challenge in financing these enterprises in a safe and sound manner because energy policies can suddenly change. For this reason, FCA will be closely watching System institutions for loan underwriting practices that do not fully consider the risks associated with the ethanol boom.” (*Farm Credit Administration’s 2007 Annual Report on the Farm Credit System*, page 49)

The next real estate bubble?

- In 2007, the average value of farmland rose 19.6% in Nebraska, 20.9% in Wyoming and 22.6% in Iowa, according to a Farm Credit Services of America survey. The surge in farmland values is attributed to rising food prices, demand for corn-based ethanol, and the demand for second homes in the country by many urbanites. In his May 22 “Country Real Estate” column, land consultant Curtis Seltzer said that asking prices for rural land “in most places seem to be holding their own, and are trending up in certain markets.” (*Wall Street Journal*, June Fletcher, 07/25/08)

## ***Postal Service***

USPS is offering early retirement to as many as 20,000 employees, who are over 50 years of age and have 20 years of federal service

- The employees of USPS have until September 30<sup>th</sup> to decide to accept the agency's offer for voluntary early retirement (VER). Under its reorganization plan, the Postal Service has offered as many as 20,000 mail handlers, clerks, distribution operations supervisors and customer service supervisors, who are at least 50 years old and have at least 20 years of federal service, the opportunity to retire early. An agency spokesman said that the USPS's VER offer is in response to the agency's declining mail volume. Employees in those positions who have at least 25 years of service also will be eligible. The agency's VER offer comes with a substantial penalty—essentially a 2% a year reduction in the annuity for every year of service below the minimum usually required for retirement—which will discourage many employees from accepting the offer. On August 18<sup>th</sup>, the Postal Service mailed annuity estimates to eligible employ and sent them retirement applications on August 22nd. Employees who apply and are approved for early retirement will leave the USPS on December 31st.” ([https://liteblue.usps.gov/news/link/2008/nl\\_0717vera.htm](https://liteblue.usps.gov/news/link/2008/nl_0717vera.htm); *Federal Times*, Stephen Losey, 07/18/08; *Government Executive*, Brittany R. Ballenstedt, 07/11/08)

Will the USPS soon become a much smaller organization?

- *Multichannel Merchant* reports: “After years of managing volume, the U.S. Postal Service wants to instead manage mail quality, according to Hamilton Davison, executive director of the American Catalog Mailers Association. ‘The post office is not just making sure that mailers get stuff delivered, it’s making sure that the mail is really wanted,’ Davison said during a session ...at the MeritDirect Business Mailers Co-op and Conference. Davison’s information stems from discussions with Postmaster General John E. Potter during ACMA’s National Catalog Advocacy & Strategy Forum last month. Potter suggested then that the USPS may soon become a much smaller organization that would not longer be handling more than 200 billion pieces a year, including 50 billion flats. (*Multichannel Merchant*, Tim Parry, 07/11/08)

APWU files a lawsuit against President Bush and Postmaster General Potter

- On July 16<sup>th</sup>, the American Postal Workers Union filed a lawsuit against President George W. Bush and Postmaster General John E. Potter in District Court over their failure to appoint a Postal Service Advisory Council, as required by federal law. “The Postal Service is required to ‘consult with and receive the advice of the Advisory Council regarding all aspects of postal operations,” wrote APWU President

William Burrus wrote in an April 11<sup>th</sup> letters to the president and postmaster general “Despite my entreaties, the advisory panel has not been appointed.” The lawsuit asks that the president and postmaster general be ordered to perform their “non-discretionary duties” by appointing the Postal Service Advisory Board. (*APWU Web News Article #68-08*, William Burrus, July 17, 2008)

## **TVA**

The Nuclear Regulatory Commission extends the TVA’s construction permit for Unit 2 nuclear reactor at its Watts Bar plant

- The Nuclear Regulatory Commission has extended its construction permit issued the unfinished Unit 2 at the Watts Bar nuclear power plant to March 31, 2013. Agency spokesman Roger Hannah said the NRC’s staff “found no significant impact on the environment” would result by extending the construction permit until 2013 so that construction could be complete. TVA is spending \$2.5 billion to complete a second reactor at Watts Bar, which the utility had begun in 1974, halted in 1985, and subsequently restarted construction this year. (*Chattanooga Times Free Press*, 07/11/08)

A federal appeals court ruling strikes down EPA rule on interstate air pollution

- On July 11<sup>th</sup>, the U.S. Court of Appeals for the District of Columbia Circuit ruled that the Environmental Protection Agency overstepped its authority by instituting the “unfair and unworkable” clean-air rule. Citing “more than several fatal flaws,” the court scrapped the entire Clean Air Interstate Rule, which would have required 28 mostly Eastern states to reduce emissions that form fine particles and ozone, which can travel hundreds of miles on the wind. The EPA had predicted the rule would prevent about 17,000 premature deaths a year. The court’s ruling was somewhat a surprise, even to industry groups that had challenged aspects of the rule. Many utilities liked the emissions “cap-and-trade” feature in the rule and had invested billions of dollars in preparations for the development of a trading market.
- Ryke Longest, director of the Environmental Law and Policy Clinic at Duke University’s law school, said it will likely to be years before a new rule can be put into effect. In the meantime, Longest said that the states will look to the courts to address interstate pollution problems. On July 7<sup>th</sup>, a federal judge in Asheville, NC began hearing testimony on a lawsuit brought by North Carolina, in which the state claims pollution from TVA’s coal-fired power plants in Tennessee, Kentucky and Alabama are a public nuisance that hurt N.C. public health and the environment.

“The lawsuit is the last resort,” said State Attorney General Roy Cooper said. “We can’t wait for clean air. It’s important for TVA to start taking steps now to clean up its coal-fired plants.”

- North Carolina is demanding that TVA to lower emissions to levels comparable to its Clean Smokestacks Act by 2013. TVA contends that it is already working to reduce emissions and will to continue to do so by 2013. The utility’s attorneys also argue that North Carolina is basing its emissions estimates on the unreasonable assumption that the TVA won’t make improvements in the next few years. In April, TVA agreed to install a \$597 million pollution control system on a coal-fired power plant in eastern Tennessee and has plans to install similar equipment at two other plants near North Carolina which should be online by 2012. To date, TVA has spent \$4.8 billion during the past few decades to improve air quality and emissions at its facilities, said TVA spokeswoman Barbara Martocci. Moreover, the utility currently is spending another \$1 billion to reduce air emissions and has budgeted to spend an additional \$3 billion on such improvements over the next decade. (*Associated Press*, Mike Baker, 07/13/08; *Charlotte Observer*, Bruce Henderson, 07/11/08)

Volkswagen announces plans to build a new production facility in Chattanooga, TN

- Volkswagen Group of America, Inc. announced it will build a U.S. automotive production facility in Chattanooga, TN, where it will produce a car designed specifically for the North American consumer and invest \$1 billion in the economy. The announcement is an important element of the company’s overall U.S. strategy of connecting with its customers, increasing its competitiveness and tripling its U.S. customer base in the next decade. Stefan Jacoby, President and CEO of Volkswagen Group of America, said, “Chattanooga is an excellent fit for the Volkswagen culture, having an exceptional quality of life and a long manufacturing tradition.” The company will build the facility 12 miles northeast of downtown Chattanooga at a 1,350-acre site owned by the city of Chattanooga and Hamilton County, which is certified as an industrial megasite by the TVA. Initial production capacity for the facility is anticipated to be 150,000 vehicles, including a new midsize sedan designed specifically for the North American market. Production is scheduled to begin in early 2011. Volkswagen says the new plant will inject \$1 billion in the local economy. (*Volkswagen Group of America Press Release*, 07/15/08)

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